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REPORT OF THE WORKING GROUP ON THE NEW INTERNATIONAL ECONOMIC ORDER ON THE WORK OF ITS SIXTH SESSION (Vienna, 10-20 September 1984)

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INTRODUCTION

1. At its eleventh session the United Nations Commission on International Trade Law decided to include in its work programme a topic entitled "The legal implications of the new international economic order" and established a Working Group to deal with this subject. 1/ At its twelfth session the Commission designated member States of the Working Group. 2/ At its thirteenth session the Commission decided that the Working Group should be composed of all States members of the Commission. 3/ The Working Group consists of the following 36 States: Algeria, Australia, Austria, Brazil, Central African Republic, China, Cuba, Cyprus, Czechoslovakia, Egypt, France, German Democratic Republic, Germany, Federal Republic of, Guatemala, Hungary, India, Iraq, Italy, Japan, Kenya, Mexico, Nigeria, Peru, Philippines, Senegal, Sierra Leone, Singapore, Spain, Sweden, Trinidad and Tobago, Uganda, Union of Soviet Socialist Republics, United Kingdom of Great Britain and Northern Ireland, United Republic of Tanzania, United States of America and Yugoslavia.

2. At its first session the Working Group recommended to the Commission for possible inclusion in its programme, inter alia, the harmonization, unification and review of contractual provisions commonly occurring in international contracts in the field of industrial development. 4/ The Commission at its thirteenth session agreed to accord priority to work related to these contracts and requested the Secretary-General to undertake a study concerning contracts on the supply and construction of large industrial works. 5/

1/ Report of the United Nations Commission on International Trade Law on the work of its eleventh session, Official Records of the General Assembly, Thirty-third Session, Supplement No. 17 (A/33/17), para. 71.

2/ Report of the United Nations Commission on International Trade Law on the work of its twelfth session, Official Records of the General Assembly, Thirty-fourth Session, Supplement No. 17 (A/34/17), para. 100.

3/ Report of the United Nations Commission on International Trade Law on the work of its thirteenth session, Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17 (A/35/17), para. 143.

4/ A/CN.9/176, para. 31.

5/ Report of the United Nations Commission on International Trade Law on the work of its thirteenth session, Official Records of the General Assembly, Thirty-sixth Session, Supplement No. 17 (A/35/17), para. 143.

3. The study 6/ prepared by the Secretariat was examined by the Working Group at its second and third sessions. 7/ At its third session the Working Group requested the Secretariat, pursuant to a decision of the Commission at its fourteenth session, 8/ to commence the drafting of a legal guide on contractual provisions relating to contracts for the supply and construction of large industrial works. 9/ The legal guide is to identify the legal issues involved in such contracts and to suggest possible solutions to assist parties, in particular from developing countries, in their negotiations. 10/

4. At its fourth session the Working Group examined a draft outline of the structure of the legal guide and some sample draft chapters prepared by the Secretariat 11/ and requested the Secretariat to proceed expeditiously with the preparation of the legal guide. 12/ At its fifth session the Working Group discussed some other draft chapters and a note on the format of the guide. 13/ There was general agreement that the work on the legal guide should proceed as quickly as possible and that two sessions of the Working Group should, whenever feasible, be held every year in order to expedite the work. 14/

5. The Working Group held its sixth session at Vienna from 10-20 September 1984. All members of the Working Group were represented with the exception of Algeria, Central African Republic, Cuba, Cyprus, Guatemala, Hungary, India, Nigeria, Senegal, Sierra Leone, Singapore, Trinidad and Tobago, and United Republic of Tanzania.

6/ A/CN.9/WG.V/WP.4 and Add.1-8, and A/CN.9/WG.V/WP.7 and Add.1-6.

7/ A/CN.9/198, paras. 11-80, and A/CN.9/217, paras. 13-129.

8/ Report of the United Nations Commission on International Trade Law on the work of its fourteenth session, Official Records of the General Assembly, Thirty-sixth Session, Supplement No. 17 (A/36/17), para. 84.

9/ A/CN.9/217, para. 130.

10/ Report of the United Nations Commission on International Trade Law on the work of its fourteenth session, Official Records of the General Assembly, Thirty-sixth Session, Supplement No. 17 (A/36/17), para. 84.

11/ A/CN.9/WG.V/WP.9 and Add.1-4.

12/ A/CN.9/234, paras. 51-52.

13/ A/CN.9/WG.V/WP.9/Add.5; A/CN.9/WG.V/WP.11 and Add.1-4 and 6-9.

14/ See A/CN.9/247, para. 132.

6. The session was attended by observers from the following States: Argentina, Bulgaria, Canada, Chile, Dominican Republic, Ecuador, Finland, Holy See, Indonesia, Netherlands, Qatar, Republic of Korea, Saudi Arabia, Switzerland, Thailand and Venezuela.

7. The session was also attended by observers from the following international organizations:

(a) United Nations organs
United Nations Industrial Development Organization

(b) Intergovernmental organizations
Asian-African Legal Consultative Committee, Commission of the European Communities

(c) International non-governmental organizations
International Bar Association, International Chamber of Commerce, International Federation of Consulting Engineers and International Progress Organization.

8. The Working Group elected the following officers:

Chairman: Mr. Leif SEVON (Finland)*

Rapporteur: Ms. Jelena VILUS (Yugoslavia)

9. The Working Group had before it for examination draft chapters of the legal guide on drawing up international contracts for construction of industrial works on "Damages" (A/CN.9/WG.V/WP.11/Add.4), "Liquidated damages and penalty clauses" (A/CN.9/WG.V/WP.11/Add.5), "Scope and quality of works" (A/CN.9/WG.V/WP.13/Add.1), "Completion, acceptance and take-over" (A/CN.9/WG.V/WP.13/Add.2), "Allocation of risk of loss or damage" (A/CN.9/WG.V/WP.13/Add.3), "Insurance" (A/CN.9/WG.V/WP.13/Add.4), "Sub-contracting" (A/CN.9/WG.V/WP.13/Add.5), and "Security for performance" (A/CN.9/WG.V/WP.13/Add.6).

10. The Working Group adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Consideration of draft chapters of the legal guide on drawing up international contracts for construction of industrial works.
4. Other business.
5. Adoption of the report.

11. The Working Group proceeded to discuss each draft chapter in the order presented below.

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* The Chairman was elected in his personal capacity.

SCOPE AND QUALITY OF WORKS 15/

12. The general observation was made that the chapter should be re-examined with a view to making it shorter, and making the terminology more consistent.

13. It was noted that it would be difficult to include illustrative provisions in this chapter, as the chapter dealt with the scope and quality of works of different kinds, which would require different types of description of scope and quality. Furthermore, in general, the legal issues dealt with in the chapter were not ones which needed to be clarified through illustrative provisions. It was suggested, however, that the issues dealt with in section E ("Extent of confidentiality of specifications, drawings and other technical documents") might appropriately be the subject of illustrative provisions. It was also suggested that the text might be shortened and clarified by the use of sample forms of some of the types of documents referred to. A further suggestion was that the chapter might include a check list of the types of documents which might be prepared for the purposes of a contract (e.g. the principal contract document, the invitation to tender, the tender, drawings, specifications, bills of quantities) and that such a check list might assist the parties to determine which documents should form part of the contract.

14. There was wide agreement that the guide should recommend that the principal contract document should clearly determine which documents relating to scope and quality formed part of the contract. It was suggested that, in view of the large volume of documents which might be prepared by different individuals at different times for the purposes of the contract, the guide should recommend that the legal advisers of the parties should examine all the documents for the purpose of ensuring consistency, and to determine which documents formed part of the contract. It was also suggested that the contract should specify in detail the scope and quality required, since in the absence of such detail the law governing the interpretation of the contract might give it a restricted ambit as regards scope and quality.

15. It was observed that in complex contracts provisions concerning the scope and quality of construction might be contained in several lengthy documents which were physically separate from the principal contract document. Accordingly, care should be taken to incorporate by reference these separate documents in the main contract documents.

16. The view was expressed that the term "turnkey" did not have a settled meaning under most legal systems and that the obligations imposed on a contractor by the mere use of that term were unclear. It was therefore necessary to elaborate clearly the obligations of the contractor under such a contract. An obligation on the contractor to perform obligations which were usual or necessary, having regard to the intended purpose of the contract,

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15/ A/CN.9/WG.V/WP.13/Add.1.

might not be sufficient to identify the contractor's obligations, and the parties should attempt to formulate a more precise description of the residuary obligations of a turnkey contractor.

17. It was noted that defining the scope of construction by reference to a model might lead to difficulties, as the model might be altered, damaged or destroyed, and it would be difficult to ascertain what was contained in the original model. Furthermore, it may be difficult to resolve all issues in a model.

18. It was noted that the term quality was used in the chapter in two senses. Firstly, it was used to indicate the nature of materials or services, and secondly, to indicate the level of excellence of the materials or services. It was proposed that in re-drafting the chapter these two senses should be distinguished.

19. There was wide agreement that the use of terms such as "first class" to indicate a level of excellence resulted in uncertainty. It was suggested that descriptions in terms of properties or characteristics of the materials or services in question (e.g. the strength of steel to be used) might be more precise. It was also observed that the words "new and at least of regular commercial quality" appeared to have acquired a degree of settled meaning in commercial practice.

20. The view was expressed that a general description of the nature of materials and services in both the principal contract document and the specifications might lead to inconsistency. Accordingly, it might be preferable to include such descriptions only in the specifications. It was noted, however, that some degree of description of the construction to be effected was necessary in the principal contract document, and that such a description might have to include a brief reference to the level of excellence. There was agreement that while the chapter should describe the various types of specifications, the terms "performance" specifications and "design" specifications should not be used in the chapter.

21. It was observed that the possible relationship between the nature of specifications to be included in invitations to tender, and methods of pricing, was complex, and might be better dealt with in the chapter of the guide relating to tendering procedures.

22. It was noted that the term "standard" could be understood in one of two meanings. It could refer to legal safety requirements relating to equipment or materials to be supplied, or it could refer to approved descriptions of the characteristics of equipment or materials to be supplied laid down by professional engineering bodies or trade associations. The parties would normally have autonomy in regard to the adoption of the latter type of standards. It was also noted, however, that the country of the purchaser might have its own mandatory standards in respect of works to be constructed in that country.

23. The view was expressed in this connection that the term "applicable law" was ambiguous: it might mean the law applicable to the contract, or the law of the country of the purchaser or the contractor making mandatory the use of certain standards in regard to equipment or materials. The use of the term in the guide should be clear.

24. It was observed that when agreeing on the use of standards, the standards in question should be clearly identified (e.g. by reference to the country or body which issued the standard, and the date on which the standard was issued). It was also observed that requirements in invitations to tender as to certain standards to be observed by the contractor might have the effect of preventing contractors unfamiliar with these standards from tendering.

25. In respect of inconsistencies between drawings and specifications both supplied by the purchaser, it was noted that when such inconsistencies were brought to his notice the purchaser should be obligated to resolve them within a short period of time. Furthermore, the purchaser should be obligated to bear any costs incurred by the contractor as a result of an inconsistency.

26. In regard to approval by the purchaser of detailed drawings made by the contractor, it was suggested that such approval might not be always needed or be practicable, in view of the frequent changes required during the course of construction. Moreover, in relation to certain techniques of rapid construction (sometimes known as "fast track" construction), the detailed scope of the works, and thus the drawings, were produced and agreed upon as the work progressed. Accordingly, if approval of drawings by the purchaser were to be required, it should be required to be given within a very short time. The purchaser should bear the consequences of delay in giving approval (e.g. bear resulting costs, or grant an extension of time for completion). It was also noted that if the purchaser in fact expressly or impliedly approved detailed drawings, he should not later be entitled to require changes in such drawings or to require changes in construction effected on the basis of such approved drawings.

27. It was observed that drawings might be prepared jointly by the parties, and that the parties should consider how errors in such drawings might be rectified, and how the liability should be allocated.

28. It was noted that, if specifications and drawings supplied by the purchaser were inaccurate or insufficient, the purchaser should not only be obligated to pay costs incurred by the contractor as a result of such errors, but also to bear the costs to the contractor of any resulting interruption of performance.

29. The view was expressed that, even when the parties entered into a contract in which the obligations assumed by the contractor had been described in terms of a specified result (e.g. a turnkey contract), the purchaser should have the responsibility for errors (e.g. omission of a part of the construction, or requiring the use of unsuitable equipment, materials or services) in specifications and drawings supplied by him. If a purchaser wished to avoid such responsibility, he should obligate the contractor to prepare the specifications and drawings. Alternatively, if the purchaser wished to supply

the specifications and drawings, he could obligate the contractor to notify him of errors which the latter discovered or should discover, and the contractor should bear the consequences of a failure to notify.

30. It was agreed that section D ("Hierarchy of documents") should be placed immediately after section B ("Determination of scope and quality of works in contract documents"). It was also suggested that the title of section D might be changed to reflect the changes suggested in the scope of that section.

31. It was observed that the guide should more clearly emphasize the likelihood of inconsistencies existing between the various documents which comprise a complex contract, and draw attention to the need to make every effort to eliminate such inconsistencies.

32. It was noted that it was difficult to lay down categorical rules as to which of the contract documents was to prevail in case of inconsistency. While from the standpoint of a lawyer it might be preferable for specifications which were in the text of the main contract to prevail over drawings which consisted of diagrams, an engineer might prefer the opposite result. There was wide agreement that several factors might be relevant to determine which document was to prevail (e.g. which document embodied the later agreement of the parties, the nature of the conflict between the documents, or which document principally focused on the issue in question). It might be preferable to recommend that the documents should in the first instance be construed as mutually explanatory, and in case of irreconcilable conflict that the matter be referred to an expeditious form of dispute settlement.

33. There was wide agreement that the problems relating to the confidentiality of specifications, drawings and other technical documents needed more extensive treatment. It was suggested that three distinct concepts, i.e. ownership, copyright and confidentiality, needed to be considered in relation to such documents.

34. The view was expressed that the concept of confidentiality might give rise to several difficulties. The parties should be encouraged to identify clearly the documents which they wished to remain confidential, the extent of the confidentiality desired, and the duration of the confidentiality. It was noted that mandatory laws might regulate the extent to which confidentiality might be accorded, and also obligate the parties to disclose the contents of documents to public authorities in the country of the purchaser or the contractor. Difficulties might also arise in relation to the clause on confidentiality if the contract was terminated, or if the purchaser later wished to employ another contractor to modify or improve the works, or if confidential documents needed to be disclosed in legal proceedings between the parties. The parties should also be advised to provide for the remedies which the aggrieved party should have in the event of a breach of confidentiality.

35. It was agreed that, after the re-drafting of the text of the chapter, the summary should be re-examined to ensure consistency between the text and the summary.

COMPLETION, ACCEPTANCE AND TAKE-OVER 16/

36. The view was expressed that the concepts of completion and acceptance should be modified. Completion might be considered to occur when the contractor performed his obligation to construct the works and mechanical completion tests were successfully conducted. The concept of acceptance might include the approval by the purchaser of construction of the works, even if this approval was in certain situations only deemed to be given.

37. It was suggested that the terminology used in the chapter should be made more consistent, and that the sequence in which tests, completion, take-over and acceptance occurred should be made more evident. A suggestion was made that the discussion of mechanical completion tests now contained in the chapter on Inspection and tests might be moved to this chapter.

38. It was noted that in construction practice take-over of the works usually followed completion, and that acceptance usually occurred after a successful trial operation of the works. It was suggested that the draft chapter, and in particular paragraph 1, should be redrafted so as to reflect this practice.

39. A question was raised as to whether it was advisable to distinguish between take-over and acceptance. The prevailing view was that such a distinction was desirable, since take-over and acceptance might occur at different times and might have different consequences.

40. A suggestion was made that paragraph 4 should be re-drafted so as to make it clear that the period of time for completion of construction might commence to run when all of the relevant events referred to in that paragraph had occurred. According to an additional suggestion, subparagraph (d) of paragraph 4 should be modified to suggest that the period of time for completion of construction might commence to run on the date on which the purchaser delivered to the contractor a design, drawings or descriptive documents of adequate quality.

41. The view was expressed that the importance of the time for completion and the time-schedule should be stressed in the guide, and that the parties should be advised to settle these issues in the contract itself, and not to postpone agreement on them until after the contract had been concluded. It was suggested that the purchaser might be entitled to order the contractor to speed up construction if it appeared that a deadline might not be met. It was further suggested that the purchaser might establish milestone dates for achieving progress in the course of the construction, but that the contractor should establish the construction schedules for meeting those milestone dates. The contractor should be liable only for delay in meeting the milestone dates and for additional costs incurred by the purchaser as a result of the delay. According to a further suggestion, the time for completion might be subjected to a condition, and, if the condition occurred, the rules governing the providing of an extension of time for performance in the case of an exempting impediment might be made applicable. A suggestion was made that the method of calculating the extension of time for completion discussed in paragraph 14 should be dealt with in detail.

16/ A/CN.9/WG.V/WP.13/Add.2.

42. A view was expressed that section B, 3, dealing with extension of the time for completion, should be deleted, since the situations in which such extension should occur were dealt with in other chapters. However, the prevailing view was that it was advisable to retain these paragraphs in this chapter since the chapter might be read independently of the others. A suggestion was made that the discussion of the time-schedule (section B, 2) should be located in another chapter.

43. A suggestion was made that the grounds for extension of time for completion discussed in paragraph 12 (b) should not be limited to administrative regulations issued after the conclusion of the contract. A view was expressed that in all the cases described in paragraph 12 an extension of time should automatically be available to the contractor, if he wanted one. It was also suggested that paragraph 13 should be deleted, or brought into harmony with the treatment of this subject in the chapter on liquidated damages and penalty clauses.

44. A view was expressed that the parties should agree upon a special mechanism to facilitate the quick settlement of disputes concerning the time for completion and the time-schedule, as well as disputes concerning the results of performance tests.

45. According to one view the guide should deal with the consequences of extension of time for performance on insurance, security interests and costs. According to another view, these issues should not be discussed in this chapter; however, reference might be made to the chapters dealing with these issues.

46. A view was expressed that the last sentence of paragraph 18 should deal not only with delay but also with the costs which might be incurred in connection therewith.

47. It was suggested that the guide might advise that a protocol reflecting the condition of the works should be signed at the time of completion of the works.

48. Differing views were expressed concerning the consequences of delay for which the purchaser was responsible in the conduct of mechanical completion tests. According to one view, in such a case completion should be presumed to have occurred, and the guarantee period should commence to run. According to another view, the only consequence should be that the purchaser should be liable to compensate the contractor for losses incurred by the contractor as a result of the delay.

49. A view was expressed that consideration should be given to harmonizing the statement in paragraph 17 that mechanical completion tests might be considered successful even if certain items are found to be missing, and the statement in paragraph 20 that performance tests might be considered successful if the works are found to be free of serious defects. It was suggested that it would not be advisable to indicate that the purchaser might authorize the carrying out of performance tests before mechanical completion tests.

50. The importance of formalities connected with the conduct of mechanical completion or performance tests, and the necessity to comply with such formalities in some cases, was stressed. It was suggested to distinguish between the participation in such tests of an inspecting organization chosen by the parties, and inspection by a regulatory organization under mandatory legal rules which was necessary in some countries before putting the works into operation.

51. It was noted that supply of some documentation (e.g. operation and maintenance manuals) by the contractor should be required by the stage of mechanical completion or performance tests. The expression in paragraph 19, i.e. "to prove in any other manner", was considered to be too vague, and the guide should attempt to envisage other possible methods of proof.

52. It was suggested that this chapter should deal with provisional acceptance. The view was expressed that the chapter should discourage the use of provisional acceptance, unless the contract specified when it occurred and what consequences it had. It was noted that in practice the term "provisional acceptance" was sometimes used as a substitute for the term "take-over".

53. Various views were expressed concerning the consequences of a failure to conduct performance tests. According to one view such a failure should result in presumed acceptance. Under another view the consequences should be more limited. It was suggested that the contract should provide a time-limit within which performance tests had to be conducted, and should also provide for the consequences of a failure to conduct the tests within that period.

54. It was suggested that the guide should indicate what an acceptance protocol should contain, and that including an illustrative form of a protocol might be useful. It was observed that it might be useful to distinguish between acceptance by the purchaser unilaterally, and the execution by both parties of an acceptance protocol, which might contain the agreement of the parties as to missing items to be supplied and defects to be cured.

55. It was pointed out that presumed acceptance might occur in certain cases in addition to those where performance tests could not be conducted due to reasons for which the purchaser was responsible. In addition to the consequences of acceptance mentioned in paragraphs 29 to 31, the guide might deal with the consequences of acceptance on such matters as security for performance, insurance and payment of the price. It was suggested to mention in paragraph 31 that a guarantee period should commence to run in respect of a portion of the works when that portion was accepted by the purchaser.

56. It was agreed to deal in this chapter only with take-over of the plant during construction and the completed works, and not with take-over of equipment and materials prior to their incorporation in the works. It was noted that the term "possession" in the definition of take-over might be interpreted in different ways under various legal systems. It was suggested that the terms "physical possession" or "control" might be used. In respect of the delivery of equipment and materials, it was recommended to use the terminology of the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980).

57. It was suggested to redraft paragraph 36 so as to avoid the interpretation that the contractor had an obligation to give all instructions to the purchaser's personnel needed for the operation of the works. It was noted that the allocation of costs during the trial operation period need not always follow the principle indicated in paragraph 36. A view was expressed that the responsibility of the contractor during the trial operation period might depend on whether the purchaser's personnel were to be trained by the contractor.

58. The view was expressed that the title of section D (1) (c) should refer to termination of the contract by the purchaser due to a failure to perform by the contractor. It was suggested to avoid reference in paragraph 37 to the concept of partial termination of the contract. It was also suggested to deal with the consequences of termination upon guarantees either in the chapter on Termination or in the chapter where the guarantee was discussed.

59. It was suggested to redraft paragraph 38 so as to suggest that if the purchaser chose the remedy mentioned in this paragraph, take-over might occur. It was also suggested to make reference to the chapters on Failure to perform and Passing of risk.

60. It was suggested that a take-over protocol might not be needed in cases where acceptance occurred and take-over took place immediately thereafter. It was also suggested that the discussion of the take-over protocol should be expanded.

61. It was pointed out that, since paragraphs 40 to 41 did not deal with take-over of the plant during construction or the completed works, the issues discussed in those paragraphs should be discussed in other chapters.

62. Various suggestions were made for improving the drafting of this chapter. It was agreed that a redrafted chapter should be examined by the Working Group at an early date and that the terminology should then be reexamined.

ALLOCATION OF RISK OF LOSS OR DAMAGE 17/

63. It was agreed that the present title of this chapter ("Allocation of risk of loss or damage") should be changed to "Passing of risk". The general observation was made that the drafting of the chapter might be improved, and specific suggestions for improvement were brought to the attention of the Secretariat. The view was expressed that the chapter should deal only with loss of or damage to equipment, materials, the plant during construction and the completed works caused by accidental events or by the acts of third persons for whom neither party to the contract was responsible. It was noted, however, that it might be useful to refer in this chapter to other chapters of the guide dealing with loss of or damage to equipment, materials, the plant during construction or the completed works caused by a party, or third persons

17/ A/CN.9/WG.V/WP.13/Add.3.

for whom a party was responsible. The view was expressed that the chapter should point out that whoever would be held responsible for the risk of loss or damage should have the right to control the situation which could give rise to such loss or damage.

64. It was suggested that in section A ("General remarks"), the first sentence of paragraph 3 should be deleted, and that instead the paragraph should indicate that often the rules as to the passing of risk in many legal systems were formulated with reference to sales contracts, and did not necessarily envisage some of the special problems arising in relation to works contracts. It was also suggested that section A should indicate that, under the recommendations made in this chapter, the time of the passing of risk in respect of equipment, materials, the plant during construction or the completed works might not coincide in some cases with the time of the transfer of property.

65. The view was expressed that the discussion in this chapter of the relationship between the passing of risk and liability for defective performance was unclear, and should be omitted. Issues relating to liability for defective performance should be dealt with in the chapter on Failure to perform.

66. It was suggested that paragraph 8 should be redrafted to clarify that it dealt with the issue of the passing of risk, and did not relate to the effect of exempting impediments. The distinction drawn between these two issues in paragraph 2 should be more clearly formulated. The view was also expressed that all the events mentioned in paragraph 8 were not in practice excluded by the parties from the risk of loss or damage borne by the contractor, and that the paragraph should be modified accordingly.

67. It was suggested that this section should include a paragraph dealing with the interrelationship of the passing of risk to connected issues dealt with in other chapters, such as insurance and the transfer of property. It was also suggested that consideration might be given to a change in the sequence of some of the paragraphs in this section, as this might facilitate understanding.

68. The view was expressed that the chapter should indicate the interrelationship between the bearing of risk in respect of equipment and materials supplied by the contractor for incorporation in the works (section B) and the bearing of risk in respect of the plant during construction and the completed works (section D). It was noted that the relevance of the presence of the contractor's personnel on the site at the time of the supply of equipment and materials to the passing of risk in respect of such equipment and materials should be reconsidered. It was observed that it was sometimes difficult to provide for the passing of risk at a time when it was possible to check the condition of the equipment and materials, and it was also observed that provision for the passing of risk at the time when the customs formalities were concluded at the frontier of the country from which the equipment and materials were exported was not often found in practice.

69. It was suggested that the need for rules on the passing of risk for works contracts which were different from the rules for sales contracts should be emphasized, since the obligations of a contractor under a works contract were not performed by mere delivery of equipment and materials, but by the use of such equipment and materials for the purposes of construction. The contractor should therefore generally bear the risk of loss of or damage to equipment and materials.

70. It was observed that it might be useful to clarify the notion of "incorporation" of equipment and materials in the works, and in particular to clarify the point of time at which such incorporation occurred. It was also observed that the approach set forth in paragraph 15 (a) to (c) providing for the risk to pass at specified times, and the approach set forth in paragraph 16 for a determination of the passing of risk by reference to INCOTERMS, were not in substance different approaches, but were different methods of formulating the same approach.

71. Different views were expressed concerning the identity of the person who should bear the risk of loss of or damage to the plant when several contractors were engaged for the construction. Under one view it was practicable for each separate contractor to bear the risk in respect of the portion constructed by him. Under another view, at least when a portion of the plant was being constructed by the use of equipment and materials supplied by one contractor, and services supplied by another contractor, this approach was not practicable, and the purchaser should bear the risk. It was suggested that in most cases the time of take-over of the works should be the relevant time for the passing of risk, and not the time of acceptance.

72. The question was raised whether the issues discussed in section E ("Consequences of bearing of risk") should be dealt with in another chapter. The prevailing view, however, was that these issues should be dealt with in this chapter.

73. The obligation of a party who bore the risk in respect of property to make good loss or damage covered by the risk was considered. There was wide support for the suggestion that, if so requested by the purchaser, the contractor should be obliged to make good, at the expense of the purchaser, loss of or damage to property the risk of which was borne by the purchaser. Reservations were expressed, however, as to whether the purchaser should in such cases be obliged to make good such loss or damage if he did not request the contractor to do so. In this connection the view was expressed that the meaning of the term "to make good" should be clarified. It was also suggested that the obligation of the purchaser to pay the price for property lost or damaged in respect of which he bore the risk should be emphasized. It was noted that, while section E suggested that the obligation of the contractor to make good loss of or damage to property the risk of which was borne by the purchaser should end with the expiry of the guarantee period, another possible approach was to make that obligation end upon take-over or acceptance of the works by the purchaser.

74. It was suggested that no distinction should be made in respect of the period of time within which the loss or damage was to be made good, as between the party who bore the risk and the other party. Whichever party was under the contract obliged to make good the loss or damage should be obliged to do so with all possible speed. It was also suggested that reference should be made to a right to use damaged but serviceable equipment pending its repair or replacement.

75. It was suggested that the last two sentences in paragraph 25 should be deleted, as the issue dealt with therein did not primarily relate to the passing of risk.

DAMAGES 18/

76. It was suggested that this chapter should contain a discussion of the relationship between damages and other remedies, such as liquidated damages and penalties and other forms of compensation which might be payable by a party. This discussion should refer to the availability of such remedies in situations in which there was a breach of contract as well as in situations in which there was no breach.

77. A suggestion was made that the chapter should refer to the types of losses which the parties should take into consideration in drafting contractual provisions on damages. Various views were expressed in respect of the types of losses which should be compensated by damages. According to one view, only those types of losses which were specified in the contract should be compensated. It was suggested that the word "all" in the first sentence of paragraph 5 should be deleted. According to another view the contract should provide for all losses to be compensated by damages, except those expressely excluded by the contract. A suggestion was made that the guide should indicate that the aggrieved party might not be reasonably compensated if there were too many provisions in the contract limiting the right to damages. It was noted that the extent of the damages for which the contractor could be liable under the contract could have an impact on the contract price. It was suggested that the guide should advise parties that in drafting contractual provisions on damages they should take into consideration rules of national law concerning damages. It was suggested that as one possible approach the parties might wish to rely on such rules of national law, except to the extent that these rules were not suitable for the particular contract. In the latter event the contract might set forth different rules, unless the rules of national law were mandatory.

78. There was wide support for the principle that a party who fails to perform an obligation under the contract should be liable for damages unless the failure was due to an exempting impediment. It was suggested that the parties might wish to agree upon the situations in which no damages were to be paid. The view was expressed, however, that it might be possible to draft such a contractual provision only in terms which were too general. It was agreed that the illustrative provision contained in footnote 2 should be deleted.

18/ A/CN.9/WG.V/WP.11/Add.4.

79. Various approaches were discussed concerning the situations in which the aggrieved party should be liable to pay compensation to a third party due to a breach of contract by the other party. It was agreed that paragraph 7 should be deleted.

80. It was noted that the mitigation by the aggrieved party of his losses might be regulated by mandatory rules of national law. It was suggested that such mitigation should be treated as an obligation of the aggrieved party, and not as a limitation of damages. It was also suggested, however, that the determination of the types of losses to be compensated by damages, discussed in paragraphs 5 to 8, might have the effect of limiting damages, and that the chapter should be re-structured accordingly. An additional suggestion was made that paragraph 11 and footnote 3 should be re-drafted so as to avoid an interpretation that if a party took steps to mitigate his losses all of his losses would be compensable by damages.

81. The question was raised as to whether the concept of unforeseeability of losses referred to the types or amount of such losses. Various approaches were discussed in respect of the time which should be relevant for determining foreseeability. It was suggested that the guide should bring such approaches to the attention of the parties. A suggestion was made that the parties might agree to inform each other of changes in circumstances which might influence the extent of damages in the event of a breach. It was noted that if the time of the breach of contract were the relevant time for determining foreseeability, it might be difficult to ascertain the time of such a breach in cases other than delay.

82. Various views were exchanged with respect to indirect and consequential losses. It was stressed that the concepts of such losses differed under various legal systems. A suggestion was made that the last two sentences in paragraph 14 should be deleted. It was also suggested that the guide should contain an illustrative provision dealing with indirect or consequential losses.

83. It was noted that in most works contracts the amount of damages recoverable by a party in the event of a breach by the other party was limited, and that this practice should be reflected either in paragraph 15 or in the section on general remarks. It was noted that under national and international legal rules the liability of a carrier of goods was limited as to amount. It was suggested that the parties should be advised to take such rules into account in drafting provisions of the contract on limitation of damages. It was also noted that in practice damages were sometimes limited to the amount recovered through insurance, or to such an amount plus a percentage of the price, and there was agreement that the guide should bring these approaches to the attention of the parties.

84. It was suggested that the last section of the chapter, concerning personal injury and damage to property of third persons, should deal with contractual responsibility for such injury and damage. However, it was noted that under some legal systems mandatory rules of law might limit the internal allocation of responsibility for such injury and damage between the parties. It was noted that while the contract could not restrict the liability of the

contractor or the purchaser to compensate third persons for such injury and damage, under some legal systems third persons could benefit from contractual provisions expanding their rights to receive such compensation. A suggestion was made that the guide should discuss joint and several responsibilities of the contractor and the purchaser for personal injury and damage to the property of third persons. It was suggested that the requirement under paragraph 18 that the purchaser notify the contractor of a claim by a third person should be limited to cases where the purchaser intended to involve the contractor in the negotiations or legal proceedings concerning such a claim.

LIQUIDATED DAMAGES AND PENALTY CLAUSES 19/

85. It was suggested that at the commencement of the chapter attention should be directed to the fact that under most legal systems there were mandatory rules governing liquidated damages and penalty clauses, and that accordingly the choice of the law governing the contract was of great significance in relation to such clauses.

86. The view was expressed that the relationship between the chapter of the guide on Damages and this chapter should be examined. It was noted that both chapters related to compensation payable on failure of performance, and that the issue of limitation of liability was relevant to both chapters. In this connection it was suggested that the guide should contain a section examining the inter-relationship of damages, and liquidated damages and penalties, and the respective emphasis which the parties might wish to give to these remedies.

87. It was observed that the payment of a bonus was an effective way of stimulating performance, and that this chapter should contain a reference to the chapter dealing with clauses providing for the payment of a bonus.

88. It was noted that under some legal systems the term penalty meant an agreed sum payable on failure of performance by a party which was intended to coerce that party to perform, while under other legal systems the term had a wider meaning, and included agreed sums having purely compensatory objectives. Whenever the term was used in the guide, the sense in which it was being used should be clear.

89. It was observed that provisional liquidated damages clauses were sometimes used in practice, and that this usage should be noted in the guide. Under such a clause an agreed sum was payable by a party upon a failure of performance. The clause further provided, however, that even if the failure of performance occurred and the sum was paid, it was to be repaid to the party paying it if that party was subsequently able to prevent loss from being caused by that failure of performance.

90. The view was expressed that the purpose of liquidated damages and penalty clauses described in paragraph 2 (b) of the chapter needed clarification.

19/ A/CN.9/WG.V/WP.11/Add.5.

91. It was emphasized that the guide should concentrate on its primary purpose of assisting parties to draft a contract. Accordingly, while the guide might draw the attention of parties to differing rules in legal systems relating to liquidated damages and penalty clauses which they should consider in drafting such clauses, it was unnecessary for the guide to describe the justifications for these rules. It was also inadvisable for the guide to refer to normal rules of interpretation, as rules of interpretation might differ in different legal systems. In this connection the view was expressed that the guide should not state that, when an agreed sum was provided for defective performance other than delay, the purchaser could claim both the agreed sum and performance, as under some legal systems this was not permitted.

92. There was wide agreement with the statement in the chapter that under many legal systems, as a condition for liquidated damages or a penalty to become due, there must not only be the specified failure of performance, but there must also be liability for such failure of performance. There was general agreement that a liquidated damages or penalty clause which might provide for payment by a contractor of liquidated damages or a penalty, even if the contractor's failure of performance was caused by the purchaser, would be manifestly unfair and unacceptable. Different views were expressed, however, as to a possible statement in the guide that the parties may wish to provide that liquidated damages or a penalty were to be payable by a contractor even if his failure of performance was due to an exempting impediment. Under one view such a provision was not encountered in practice, and was unfair to the contractor. Under another view, examples of such provisions were in fact found in practice, and such provisions might not be unfair in respect of certain types of exempting impediments. Furthermore, since the issue in question related to which of two innocent parties was to bear the risk of loss caused by an exempting impediment, parties should be free to agree to allocate the risk to one or the other party. It was agreed that the guide should indicate that in exceptional cases one might find provisions under which a party was obliged to pay liquidated damages or a penalty although not otherwise liable for the consequences of a failure of performance.

93. It was suggested that section C of the chapter ("Increasing effectiveness of liquidated damages and penalty clauses") might more appropriately be entitled "How to increase the effectiveness of liquidated damages and penalty clauses". It was also suggested that an attempt should be made to make paragraph 9 more concise and clear.

94. In regard to section D ("Ceiling on recovery of agreed sum"), it was agreed that in the context of liquidated damages and penalty clauses the term "ceiling" might have more than one significance, and that an attempt should be made to use clear terminology. As regards paragraph 14, it was observed that two approaches to limitation of recovery were referred to therein and needed to be distinguished. The first approach was for the contract to provide that when liquidated damages or penalties were fixed by way of increments (e.g. a fixed amount being due per unit of delay), and a limit was placed beyond which the increments could not increase, no further recovery of any kind was possible after that limit was reached. Another approach was that, while no recovery of liquidated damages or penalties was possible after the limit was reached, it would be possible for the purchaser after the limit was reached to affirmatively prove that additional loss was suffered, and recover damages for such additional loss.

95. It was noted that section E ("Obtaining agreed sum") suggested the possibility of formulating contractual provisions under which the purchaser could recover liquidated damages or a penalty from a contractor by way of deduction from sums due from the purchaser to the contractor. It was observed that under some legal systems and in some countries the issue of deduction was regulated by mandatory rules and other requirements. It was also observed that the rules under some legal systems were such as to make provisions as to deduction of the kind suggested impracticable. For example, a court might have a mandatory power to reduce a sum agreed as a penalty, so that a deduction of an agreed sum might be later invalidated if a court reduced the agreed sum. It was noted, on the other hand, that provisions as to deduction were workable under other legal systems. It was agreed that the attention of the parties should be directed to the need to formulate provisions for deduction after consideration of the relevant legal rules and other requirements.

96. It was suggested that, even where provisions as to deduction were workable under the applicable law, the guide should describe such provisions as a possible approach. It was also observed that consideration should be given to placing in another chapter (e.g. in the chapter on Security for performance) the technique mentioned in section E of enhancing the certainty of recovery of the agreed sum through the opening of a guarantee.

97. The view was expressed that the possibility addressed in paragraph 16, i.e. the date from which the commencement of delay was to be calculated becoming inoperative by reason of certain circumstances, and the consequences of such a possibility (i.e. the inability to apply a liquidated damages or penalty clause for delay), should be more clearly formulated. It was also noted that while, as stated in paragraph 16, the contractor would in these circumstances under some legal systems be bound to perform within a reasonable time, this may not be the result under other legal systems.

98. The view was expressed that section G ("Termination of contract and liquidated damages and penalty clauses") should be restricted to advice as to the drafting of a provision regulating the effect of termination on a liquidated damages or penalty clause, and that issues such as the right to recover damages after termination should be dealt with in the chapter of the guide on Termination. It was also suggested that the language and structure of the section might be reconsidered with a view to achieving simplification.

99. There was agreement that this chapter should not only draw the attention of the parties to the "Uniform rules on contract clauses for an agreed sum due upon failure of performance" adopted by the Commission at its sixteenth session, 19/ but should also indicate that the rules might be used as a basis for resolving the often difficult issues which arose in drafting liquidated damages and penalty clauses.

19/ Report of the United Nations Commission on International Trade Law on the work of its sixteenth session, Official Records of the General Assembly, Thirty-eighth Session, Supplement No. 17 (A/38/17), Annex 1.

INSURANCE 20/

100. The view was expressed that the chapter should reflect a greater balance with respect to the provision of insurance by the contractor and the purchaser, respectively. In addition, a view was expressed that, due to the wide variety of contracts to which the legal guide was to apply, the chapter should avoid stating how particular issues concerning insurance should be resolved in the contract; rather, the chapter should draw the attention of the parties to possible approaches which they might consider with respect to these issues.

101. It was suggested that the chapter should discuss the various types of risks which often existed in connection with the construction of industrial works. A view was expressed that the parties should be advised to make themselves aware of the types of insurance which were available and the risks which could be insured against, as well as risks which were usually excluded from insurance coverage. Suggestions were made that the chapter might contain illustrative provisions with respect to the insurance to be provided. A further view was expressed that the parties should be advised that it might not be possible to insure against all risks, and that the cost of insurance against certain risks might be excessive by reason of the magnitude of these risks. A view was expressed that the parties should be advised to consider who should bear risks which could not be covered by insurance. Further suggestions were made that the chapter should point out some of the reasons why the purchaser had an interest in the contractor having insurance coverage for risks which were to be borne by the contractor, but the insurance of which was in any event ultimately to be paid by the purchaser.

102. It was suggested that the purchaser should be advised that at the pre-tender stage it would be desirable for him to consult with an international insurance broker or risk management consultant as to what insurance was available in the market, and what insurance should be required in the contract. It was also suggested that the purchaser should be advised to consider whether it would be less expensive for him to provide certain types of insurance himself, rather than require the contractor to do so. Additional views suggested that the chapter might refer to the possibilities of self-insurance and partial self-insurance by the contractor, to political risk insurance and to wrap-up insurance. According to other views, however, these possibilities should not be discussed in the chapter.

103. The view was expressed that the chapter should refer to the desirability of naming both the contractor and the purchaser as insured parties in insurance policies in order to avoid the difficulties and costs associated with the subrogation of the insurer against the party not named. It was suggested that the chapter should discuss reasons why the purchaser might have an interest in having the contract require insurance against risks and liabilities borne by the contractor.

20/ A/CN.9/WG.V/WP.13/Add.4.

104. A view was expressed that the chapter should recommend that insurance be taken out with an insurer who had the financial capacity to insure the risks, and who was acceptable to both parties. According to an additional view, the chapter should discuss the advantages and disadvantages of taking out as much of the insurance as possible with a single insurer, as opposed to several insurers. A view was further expressed that it would be desirable for the chapter to discuss means of adjusting the amount of insurance provided in order to take account of inflation. A further view was expressed that the parties should be advised to require insurance proceeds to be payable in a freely convertible or a specified currency (e.g. the currency in which the contract price was expressed).

105. With respect to insurance of the completed works, a view was expressed that the parties should be advised to consider whether this insurance should be required throughout the guarantee period. A view was expressed that when several contractors participated in the construction, it was advisable for each contractor to insure the portion of the plant during construction and completed works for which he was responsible. According to an additional view, one of several contractors should not be obligated to insure the plant and works in its entirety if he merely co-ordinated construction by the other contractors.

106. With respect to insurance of equipment and materials to be incorporated in the works, a view was expressed that the purchaser's interest in having such insurance in force began not earlier than the time when such items were shipped. It was also noted that in practice, equipment and materials in transit to the site were insured under a separate transport insurance policy. If there arose a dispute whether loss or damage occurred to equipment or materials during the transport period or during another period, under current practice the insurers covering these periods would bear equally the payment of compensation for the loss or damage. A suggestion was further made that the chapter should advise the parties that each of them should be insured with respect to loss of or damage to equipment and materials in respect of which he bore the risk of such loss or damage.

107. With respect to insurance of the contractor's equipment and tools, the view was expressed that such insurance was usually of interest only to the contractor. A suggestion was made to advise the parties to consider whether it was necessary for the contract to require such insurance; if so, the cost thereof should be borne by the contractor. It was further suggested that the chapter should take note of the difficulties which might be involved if a foreign contractor were required to take out such insurance with an insurer in the country of the purchaser.

108. With respect to liability insurance, a suggestion was made that the chapter should specify the periods of time during which the various types of such insurance should be in effect. In this regard, a view was expressed that the period of coverage of products liability insurance should be linked to the applicable legal limitation or prescription period.

109. A suggestion was also made that the parties should be advised that professional indemnity insurance might not be available to a contractor who both designed and constructed the works.

110. A view was expressed that the chapter should deal with the advisability or necessity for each of the parties to provide insurance to compensate for injury to workmen. According to an additional view the parties should be advised to require such insurance particularly in respect of workmen from the country where the works was being constructed.

111. With regard to proof of insurance, a view was expressed that the contract should set a time-limit by which such proof was to be provided by the contractor to the purchaser. Another view was that the contract should also obligate the purchaser to provide proof to the contractor of insurance required to be taken out by the purchaser. A suggestion was made that the contract should authorize one party to receive proof of insurance from an insurer providing insurance for the other party. In addition, a suggestion was made that the contract should obligate a party to instruct an insurer from whom he had obtained insurance to notify the other party if a premium was not paid.

112. According to one view the contract should be terminable by the purchaser if the contractor failed to provide insurance which he was required to provide. According to another view the contract should not be terminable in such a case, and the purchaser's remedy should be to claim damages for any loss suffered by him as a result of the failure.

113. A view was expressed that if the contract entitled the purchaser to purchase at the contractor's expense insurance which the contractor was obligated but failed to provide, the contract should obligate the purchaser to give to the contractor advance notice of his intention to purchase the insurance. According to an additional view the contractor should be responsible only for reasonable expenses incurred by the purchaser in obtaining such insurance.

SUB-CONTRACTING 21/

114. It was suggested that the chapter should recommend that the parties pay special attention to provisions on sub-contracting when negotiating and drafting their works contract, since unsatisfactory treatment of this issue could result in problems with the construction and the quality of the works. A view was expressed that the scope of the term "sub-contracting" as used in the chapter should be clarified so as to differentiate those entities which were included in the term from those which were not. For example, sub-contractors should be distinguished from suppliers.

21/ A/CN.9/WG.V/WP.13/Add.5.

115. The existence of a legal relationship between the purchaser and a sub-contractor was discussed. According to one view no legal relationship should exist between these entities. According to another view, such an approach was too absolute. In support of the latter view it was suggested that under some legal systems a legal relationship between the purchaser and a sub-contractor might exist in respect of particular issues. For example, a purchaser could claim directly against a sub-contractor for a breach of certain obligations. Under other legal systems, there existed a tripartite relationship among the contractor, purchaser and sub-contractor. A legal relationship between the purchaser and a sub-contractor might also arise in some cases from certain provisions of the contract, such as those permitting a purchaser to select or to participate in the selection of a sub-contractor, those permitting the purchaser to claim directly against the contractor, and those permitting the purchaser to pay a sub-contractor directly.

116. Views were expressed concerning the liability of the contractor to the purchaser for acts and omissions of a sub-contractor. It was suggested that various approaches to this issue should be brought to the attention of the parties. According to one approach, the contractor should be fully liable to the purchaser for the acts or omissions of a sub-contractor. According to another approach the liability of a contractor to the purchaser for the acts or omissions of a sub-contractor should be reduced or excluded if the contractor did not freely select the sub-contractor.

117. A view was expressed that the contract should authorize direct communications between a sub-contractor and the purchaser only as to technical matters or matters relating to the design or quality of the works. According to a further view the settlement of such matters between the purchaser and a sub-contractor should be effective only if it did not affect obligations of the contractor which were not to be performed by the sub-contractor. Moreover, under this view communications which were not authorized by the contract should result in the contractor's not being liable for acts taken pursuant to such communications. Suggestions were made that the contractor should have the right to be present at discussions between the purchaser and a sub-contractor, and that the contract should obligate the purchaser to inform the contractor of any communications between the purchaser and a sub-contractor. It was also suggested that the chapter should refer to the need of a sub-contractor to receive information in certain situations from the purchaser.

118. Suggestions were made that the chapter should deal with the substitution of one sub-contractor for another, with consortia which were sub-contractors and with sub-sub-contracting. It was suggested that paragraph 3 of illustrative provision 1 should be contained in a general provision of indemnity of the purchaser by the contractor.

119. With respect to the right of the contractor to sub-contract, various approaches were proposed for inclusion in the chapter. According to one approach, the contractor should be able to sub-contract freely. According to another approach, the right of the contractor to sub-contract should be restricted, and the discussion in paragraphs 7 and 8 of the chapter was appropriate in this regard. A suggestion was made that the contractor should not be permitted to sub-contract a major portion of the works. It was noted

that it might be difficult for the contract to specify which obligations of the contractor could not be sub-contracted. There was a suggestion that it would, therefore, be preferable for the contract to prohibit sub-contracting of the contractor's obligations, except those obligations which the contract specified could be sub-contracted by the contractor. It was also noted that in practice the sub-contracting of design obligations was often prohibited.

120. The selection of sub-contractors was discussed. A suggestion was made that the three approaches to this issue referred to in the chapter should be more clearly delineated. It was also suggested that the chapter should discuss all three approaches, and indicate the advantages and disadvantages of each approach.

121. The view was expressed that the parties should be advised that whenever possible, the sub-contractors should be named in the works contract. The view was also expressed that the parties should be advised that it was undesirable to provide for sub-contractors to be chosen by the contractor subject to the approval of the purchaser after the conclusion of the contract. According to this view, this approach was dangerous in works contracts, since if the purchaser objected to a sub-contractor it might not be possible to propose another sub-contractor. Moreover, this approach could result in an interruption of the work. Under the same approach, it was noted that if the purchaser controlled the sub-contracting he would have to pay any extra price incurred as a result.

122. A suggestion was made that where the sub-contractor was to be chosen by the contractor subject to the approval of the purchaser after the conclusion of the contract, the contractor should be obligated to give a copy of the sub-contract to the purchaser together with any other information in relation to the proposed sub-contracting which the purchaser might require. It was noted, however, that it might not always be possible for the contractor to inform the purchaser of the sub-contract price.

123. It was also suggested that in the cases referred to in the previous paragraph the contractor should consult with the purchaser and obtain his opinion and, subject to his approval, provide the materials referred to.

124. It was noted that the circumstances giving the purchaser an interest in the selection of a sub-contractor, referred to in paragraph 11, would exist in all cases, even in cases in which the purchaser did not participate in the selection of a sub-contractor. In addition, these circumstances also applied to the contractor.

125. It was suggested that the chapter should emphasize the importance of co-operation and communication between the parties, regardless of which approach was chosen with respect to the selection of sub-contractors. A suggestion was made that the terms of the main contract should be included in the sub-contract to ensure that the sub-contractor was bound to comply with the standards of the main contract. It was also suggested that the parties should be advised to provide a mechanism to resolve expeditiously disputes concerning the selection of sub-contractors.

126. It was agreed that the chapter should deal with the nomination system as one mechanism which the parties might consider for the selection of sub-contractors. However, the use of the nomination system should not be encouraged, and the dangers in the use of the system should be pointed out. It was suggested, for example, that under some legal systems it might be possible in some cases for a nominated sub-contractor with whom the purchaser had negotiated to claim that an agreement had been reached between the purchaser and the sub-contractor. In such a case the purchaser might be held liable to the nominated sub-contract if the nominated sub-contractor was not engaged by the contractor. In addition, the purchaser might have to bear loss or damage arising from defective performance by a nominated sub-contractor. According to another view the nomination system was satisfactory as long as the contractor was given the right to object to a sub-contractor nominated by the purchaser. The reasons given in paragraph 24 were emphasized, including the fact that national legislation might at times require the use of local sub-contractors.

127. With respect to the grounds upon which the contractor should be able to object to a sub-contractor nominated by the purchaser, it was suggested that in addition to the grounds discussed in paragraph 22, reference should be made to the fact that due to trade policies of his own country, the contractor might be able to sub-contract only with sub-contractors from certain countries. It was also suggested that the contractor should be able to object to a nominated sub-contractor if the latter was not sufficiently qualified to perform the work or was unable to indemnify the contractor fully for loss or damage arising out of the sub-contractor's acts or omissions. As a possible method of dealing with the ground referred to in paragraph 22(a) (i.e. a failure by the sub-contractor to undertake towards the contractor liabilities comparable to those imposed on the contractor towards the purchaser), it was suggested that the damages payable by the contractor to the purchaser might be limited to the damages that the contractor was able to recover from the nominated sub-contractor. According to another view, however, this method was not satisfactory; it did not resolve the situation in which the contractor incurred liability to a third person as a result of acts or omissions of the sub-contractor, and the sub-contractor did not sufficiently indemnify the contractor against such liability. In such a situation the liability of the contractor to the third person could not be reduced by the works contract.

128. A view was expressed that the responsibility of the contractor for the acts or omissions of a nominated sub-contractor, referred to in paragraph 24, was one of the approaches which should be dealt with in the chapter. According to another view, however, while that approach might be referred to in the chapter, it should not be endorsed. It was suggested that the chapter should also discuss the approach whereby the purchaser bore responsibility for the acts and omissions of a nominated sub-contractor. A view was also expressed that if the contractor failed without good reason to engage a nominated sub-contractor, he should be liable to the purchaser for any losses arising from this failure.

129. Different views were expressed concerning the liability of a contractor if a nominated sub-contractor abandoned the sub-contract or the sub-contract was terminated. Under one view the purchaser should bear the losses and expenses associated with the interruption of the work and the engagement of a new sub-contractor in cases where the contractor was not at fault. Accordingly, it was suggested that the last two sentences of paragraph 25 should be deleted. According to another view, however, the solution contained in these sentences was satisfactory if the parties agreed to it.

130. It was suggested that the chapter should point out that as a possible means to resolve the problems arising under the nomination system the purchaser might wish to engage the sub-contractor himself.

131. Various approaches were proposed to enable the purchaser to claim directly against the sub-contractor in respect of certain matters, such as obligations of confidentiality and guarantee obligations. Under one approach, guarantee obligations would be imposed on the sub-contractor by the sub-contract; under another approach, the contractor may assign all his guarantee rights against the sub-contractor to the purchaser and in this case the contractor should no longer be responsible to the purchaser. The same obligations would be imposed on the contractor in the works contract. Under some legal systems the purchaser would then be able to bring a claim against the sub-contractor in the name of the contractor for a breach of such obligations. Under another approach the purchaser, contractor and sub-contractor would become parties to a tripartite agreement containing such obligations. Under yet another approach the question of direct claims by the purchaser against a sub-contractor would be settled by national law.

132. With respect to the question of determining when direct payments by the purchaser to a sub-contractor might be justified, it was suggested that the contract might provide that as a condition to receiving progress payments from the purchaser, the contractor would be obligated to provide the purchaser with proof that previous payments by the purchaser to the contractor in respect of sub-contracted work had been applied to the sub-contractor. In the absence of such proof, or a satisfactory explanation why such previous payments had not been applied to the sub-contractor, the purchaser could pay the sub-contractor directly and deduct such payment from the amount due to the contractor. It was noted, however, that the ability of the purchaser to pay a sub-contractor directly and to deduct such sums from amounts due to the contractor might impair relations between the purchaser and the contractor. The view was expressed that the purchaser should be informed that this mechanism might lead to great risk and might involve the purchaser in disputes between the contractor and sub-contractors. It was pointed out in particular that the purchaser should beware lest he pay the sub-contractor too much. A suggestion was made that the last sentence of paragraph 30 should be reconsidered in the light of the question of whether the situation envisaged in that sentence could occur in practice.

SECURITY FOR PERFORMANCE 22/

133. The view was expressed that the chapter should emphasize the expenses which might be entailed in different arrangements for the provision of guarantees. Parties may consider whether, in view of the reputation and financial standing of a contractor, minimal guarantees might be sufficient. Where guarantees had to be provided, the chapter should advise that the comparative costs of different arrangements should be examined with a view to avoiding unnecessary expense. It was noted in particular that an arrangement under which a monetary performance guarantee was given by one bank and confirmed by another might entail considerable expense.

134. It was observed that references in the chapter to other texts should be limited. Where relevant information or contractual arrangements were contained in other texts, it was preferable to set forth that information or those arrangements in the chapter itself. If other documents were referred to, they should be texts which had in some manner been accepted by the Commission.

135. Differing views were expressed as to how widely guarantees, and in particular performance guarantees, were used in contracting practice. Under one view such guarantees were insisted on by purchasers in only a few regions, while under another view they were required in many regions, and were always required when a works contract was financed by funds from an international development institution.

136. A view was expressed that the description of a tender guarantee contained in paragraph 5 might not accord with the way in which such guarantees operated in practice. It was also suggested that the terminology used in the chapter should be clear and consistent. Thus possible confusion between a performance guarantee, and a quality guarantee relating to performance, should be avoided. Furthermore, it was noted that the term performance guarantee was used in the chapter to denote two different types of guarantee (distinguished in the chapter as "monetary performance guarantee" and "performance bond"). Accordingly, whenever the term "performance guarantee" was used, the sense in which it was being used should be clarified. It was also suggested that the presentation in the chapter might be improved if monetary performance guarantees and performance bonds were dealt with separately.

137. As regards the choice of guarantors, a view was expressed that the parties should be encouraged to agree on the guarantors to be provided before the conclusion of the contract. If there was no such choice before the conclusion of the contract, and the purchaser thereafter rejected the guarantor chosen by the contractor, the contractor might find it difficult to find another guarantor acceptable to the purchaser. A view was expressed that for the adequate protection of the purchaser it might not be necessary to insist on a guarantor from the purchaser's country, but that a guarantee from

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22/ A/CN.9/WG.V/WP.13/Add.6.

a first class bank or other financial institution, possibly from a country which was neither that of the purchaser or the contractor, might be sufficient. A view was expressed in this connection that, even if the purchaser insisted on a guarantee from a bank in his country, in practice that bank might sometimes obtain a counter-guarantee from a foreign bank, in order to ensure that sufficient convertible currency was available to satisfy the possible payment obligations under the guarantee. It was also noted that the parties should examine whether the guarantor had the financial capacity to satisfy the obligations included in the guarantee. It was suggested that the chapter should indicate that in some cases a governmental guarantee might be requested by the purchaser to support the obligations undertaken by the contractor.

138. The view was expressed that while the terms "independent" and "accessory" guarantees were often used, the terms "conditional" and "unconditional" guarantees were also used, and that this latter usage might also be mentioned in the chapter. The view was expressed that the use of the term "independent" should be reconsidered.

139. It was observed that in addition to the possible arrangements relating to recourse under first demand guarantees discussed in the chapter, the chapter might describe other possible arrangements which might help to protect the interests of both the purchaser and the contractor. One possible arrangement was for the guarantee to provide that the guarantor was not obliged to pay the purchaser immediately on demand, but only after the lapse of a specified period. The lapse of time enabled negotiations to take place between the purchaser and the contractor with a view to settling the dispute between them. Another possible arrangement was for the guarantor to pay the money on demand by the purchaser into the hands of a third party, who could hold it in trust pending resolution of the dispute between the purchaser and the contractor. It might also be possible in the works contract to provide that the purchaser must give notice to the contractor before making a demand for payment, or must give the contractor a period to cure the alleged defects before making a demand. A failure to observe these contractual terms would expose the purchaser to contractual liability to the contractor. In addition, if such contractual terms were provided, courts in some legal systems might prevent the purchaser from claiming under the guarantee in breach of these terms.

140. A view was expressed that, even when the guarantee in question was a first demand guarantee, the guarantor might not in all cases be obliged to pay on the bare assertion of the purchaser that there had been a failure of performance by the contractor. The chapter might indicate that some jurisdictions had developed certain very limited restrictions on the right of recourse of the purchaser (e.g. when the claim was made fraudulently). It was also noted that it might be helpful to distinguish clearly between the relationship between the purchaser and the guarantor, and between the purchaser and the contractor. While an unfair call under a first demand guarantee would oblige the guarantor to pay, the rights of the contractor against the purchaser for breach of contractual provisions relating to the call of the guarantee would remain unimpaired.

141. In regard to the last sentence of paragraph 18, the view was expressed that, while the parties usually did have a common interest in the successful completion of the contract, nevertheless in certain circumstances this might not be sufficient to discourage an abuse of rights under a first demand guarantee. Accordingly, there was agreement that this sentence should be deleted.

142. The view was expressed that the suggestion in the chapter that the purchaser might stipulate in his invitation to tender the guarantors whom he would be prepared to accept should be clarified. One possibility would be for the purchaser to stipulate the identity of the guarantors whom he would be prepared to accept. However, since many contractors might be unable to secure the named guarantors, it might be desirable to stipulate only acceptable types of guarantors (e.g. those providing monetary performance guarantees or those providing performance bonds). A view was also expressed that requiring a tender to be accompanied by a certificate from a prospective guarantor indicating his willingness to give a performance guarantee might not be a useful approach, as under some legal systems the undertaking in the certificate would not be enforceable.

143. It was noted that the chapter suggested in paragraph 19 that, when the guarantee was to be furnished after the conclusion of the contract, the parties should agree on the right of the purchaser to recover damages in case the guarantee was not furnished. It was observed, however, that in respect of this remedy the purchaser should carefully consider the likely value to him of such unsecured rights to damages against a foreign contractor, the amount of damages which might actually be suffered by him, and the possible difficulties involved in obtaining an award against the foreign contractor.

144. It was noted that the relevant currency for payment under both a repayment guarantee and a performance guarantee (paragraph 20) would usually be the currency in which the contract price was to be paid. It was also noted that the reference in paragraph 23 to a liability of the guarantor to pay for costs and damages suffered by the purchaser was unnecessary, since the purchaser would in practice claim a global sum under the guarantee, and was not bound to prove that he had suffered costs or damages.

145. A suggestion was made that a reference be given in section B, 2 ("Security for performance created through payment conditions") to the chapter on Price, which would contain a detailed treatment of payment conditions.

146. A view was expressed that paragraph 36 did not sufficiently reflect current practice in some regions with regard to the release to the contractor of sums outstanding from the full contract price. It was noted that the payment conditions often provided that fifty per cent of the sum outstanding was to be released upon completion of the works, and that the balance fifty per cent was to be released upon expiry of the guarantee period.

147. It was suggested that it would be useful to indicate the conditions under which it might be appropriate for a contract to require both the provision of security for performance by a contractor through guarantees, and security created through payment conditions, or to require only one form of

security. It was also suggested that, when both forms of security had been provided, the chapter should address the question of the options which might be open to the purchaser in relation to enforcement of the securities.

148. It was observed that section C ("Security for payment by purchaser") might be re-examined to ensure a balance between that section and section B ("Security for performance by contractor"). In particular, the chapter should note in paragraph 39 that it might be preferable for the contractor to have the letter of credit in his favour opened by a bank in his country, and that in addition to exchange control difficulties, the contractor might face other administrative difficulties in obtaining payment. Furthermore, as an alternative to requiring a revolving letter of credit as noted in paragraph 40, attention should be directed to the opening of a letter of credit in the amount of the full contract price. It was noted that the objective of a better balance might be achieved by a greater emphasis in section C on alternative approaches which might be adopted, rather than on specific recommendations.

149. It was noted that the mere fact that the works was financed by an international lending agency or other reputable institution might not be a sufficient assurance of payment to the contractor. Under certain contractual arrangements, payments were only due upon certification of due performance of work by an engineer who was an employee of the purchaser or pursuant to authorization by the purchaser. Circumstances might therefore occur in which certification which was appropriate did not occur, and the financial institution was unable to make payment. A method of resolving this difficulty might be for the right of the contractor to obtain payment to be activated by a procedure which was independent of the purchaser.

150. It was observed that the parties might wish to provide for the consequences which were to follow if the purchaser failed or delayed to open the letter of credit as required under the contract. It was also observed that section C should describe the deferred payment system sometimes adopted in the financing of works contracts, under which credit for the construction was granted by or on behalf of the contractor, and the purchaser undertook to make deferred payment during a period of time agreed between the parties.

151. It was suggested that a reference might be made to the methods of dispute settlement which might be adopted both when disputes arose with regard to the security to be provided by the contractor for the performance of his obligations, and with regard to the security to be provided by the purchaser for the payment of the price.

152. There was general agreement that security interests in property (section D) was not of great importance to either party as a means of securing due performance by the other party. It was noted that the subject was complex, and difficult to describe concisely. It was observed that security interests in favour of the purchaser over the construction machinery of the contractor had declined in importance, as such machinery was often leased by the contractor and not owned by him. It was agreed that the subject did not merit treatment in a separate section of the chapter, but that the contents of the present section dealing with this subject might be noted at appropriate points

in other sections of the chapter. A view was expressed, however, that the chapter might also refer to retention of title and mortgages. A view was also expressed that the parties should be reminded that it would be desirable to obtain independent legal advice on the applicable law relating to security in property that was located in another country.

OTHER BUSINESS AND FUTURE WORK

153. It was noted that two further sessions of the Working Group might be needed to complete the deliberations on most of the draft chapters to be contained in the legal guide. Several draft chapters would be prepared for the next session of the Working Group, which would be held, in accordance with the decision of the Commission, from 8 to 19 April 1985, in New York. 23/

154. The Secretary of the Commission stated that the Secretariat would submit to the seventh session of the Working Group a revision of the draft Outline of the structure of the legal guide (A/CN.9/WG.V/WP.9/Add.1) and that this revision would reflect the deliberations of the Working Group and would contain some re-arrangement and amalgamation of certain chapters as the Secretariat might consider appropriate. The Secretariat would also submit to the eighth session of the Working Group redrafted chapters on "Completion, acceptance and take-over" and on "Choice of contract type", since the original draft chapters required substantial revision in the light of the discussion by the Working Group.

23/ Report of the United Nations Commission on International Trade Law on the work of its seventeenth session, Official Records of the General Assembly, Thirty-ninth Session, Supplement No. 17 (A/39/17), para. 154.