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DRAFT UNIFORM RULES ON LIQUIDATED DAMAGES AND PENALTY CLAUSES

Analysis of the responses of Governments and international organizations

Note by the Secretary-General

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INTRODUCTION

1. At its fourteenth session, the United Nations Commission on International Trade Law considered the draft uniform rules on liquidated damages and penalty clauses prepared by its Working Group on International Contract Practices, and decided to request the Secretary-General:

"(a) To incorporate in the draft uniform rules on liquidated damages and penalty clauses prepared by the Working Group such supplementary provisions as might be required if the rules were to take the form of a convention or a model law;

(b) To prepare a commentary on the draft uniform rules;

(c) To prepare a questionnaire addressed to Governments and international organizations seeking to elicit their views on the most appropriate form for the uniform rules; and

(d) To circulate the draft uniform rules to all Governments and interested international organizations for their comments, together with the commentary and the questionnaire." 1/

2. In response to this request, the Secretariat incorporated in the draft uniform rules appropriate supplementary provisions, prepared a commentary on the draft uniform rules as so modified 2/ and also prepared a questionnaire. Thereafter, under cover of letter dated 20 November 1981 and note verbale dated 14 December 1981, the draft uniform rules were circulated to interested international organizations and all Governments for their comments, together with the questionnaire and commentary. The present document analyses the responses received as of 31 May 1982. Part I analyses the answers to the questionnaire, while Part II analyses the comments on the draft uniform rules.

3. Responses were received from the following Governments and international organizations:

Governments: Austria, Argentina, Canada, Chile, Cyprus, Japan, Republic of Korea, Philippines, Poland, Spain, Sweden, Turkey, Venezuela and the Union of Soviet Socialist Republics (USSR).

International organizations: United Nations Conference on Trade and Development (UNCTAD), and United Nations Industrial Development Organization (UNIDO).

1/ Report of the United Nations Commission on the work of its fourteenth session (1981), Official Records of the General Assembly, Thirty-sixth Session, Supplement No. 17 (A/36/17), para. 44.

2/ The modified draft uniform rules and the commentary are contained in A/CN.9/218.

PART I. APPROPRIATE FORM FOR THE UNIFORM RULES

A. Convention

4. Some States (Austria, Argentina, Chile, Cyprus, Philippines, USSR) consider a convention to be the most appropriate form for the uniform rules. A convention will generate considerable interest and be widely acceptable because it has been negotiated among a large number of States, and the uniform rules embodied in a convention may also form a model for national legislation (Chile, Philippines). A convention provides the greatest certainty of unifying the conflicting common law and civil law rules on the subject (Austria). A state which adheres to a convention must apply the rules as formulated therein as long as it remains a party to the convention (Austria, Chile, Philippines). The rules in a convention take precedence over, and are not affected by changes in, national law (Argentina, Cyprus), and this consideration makes a convention preferable despite the high cost of adopting one (Argentina).

5. As regards the procedure for adopting a convention, Argentina and Chile prefer a convention to be adopted by a conference of plenipotentiaries, although Chile proposes adoption by the General Assembly on the recommendation of the Sixth Committee if the convening of a conference of plenipotentiaries will be very costly. Argentina, however, notes that adoption by the General Assembly would also entail considerable costs, and further would delay the work of the Sixth Committee. The Philippines and the USSR prefer a convention to be adopted by the General Assembly, the Philippines for the reason that this procedure is less costly.

6. Some States which support a form other than a convention give reasons for opposing a convention. Only a limited number of States would adhere to a convention (Poland, Sweden, Turkey). The need for unification in this field is limited (Sweden, Venezuela), and the developing countries do not give priority to unification in this field (Venezuela). The small number of articles in the draft makes a convention inappropriate (Poland).

7. Japan is not opposed to a convention if a majority in the Commission prefers this form, while Canada notes that, if a convention were to be chosen, it should only apply when specifically invoked by the parties in writing.

B. Model Law

8. Some States (Japan, Poland, Republic of Korea, Spain) consider a model law to be the most effective form of unification.

9. The Commission, or the General Assembly, could recommend to States that they incorporate the model law in their national legislation (Philippines, Poland).

10. Some States which support a form other than a model law give reasons for opposing a model law. A model law may only provide limited unification because States are free to adopt a model law with modifications, and different States may make different modifications (Austria, Philippines).

C. UNCITRAL Rules (general conditions)

11. Some States (Canada, Sweden, Turkey, Venezuela) consider general conditions to be the most appropriate form. The adoption of this form furthers the principle of giving parties freedom as to the terms to be included in the contract (Canada, Turkey), and general conditions would give parties some guidance in drafting their contracts (Sweden). Furthermore, general conditions could be used by parties as soon as they are finalized by the Commission, and the uniform rules would thus be applied earlier than if one of the other forms were adopted (Canada). As general conditions the uniform rules may also have a wide application to many types of contracts (Turkey). Because unification in this field is not a matter of priority, the formulation of general conditions is the most practical and realistic approach, despite the limited unification achieved thereby (Venezuela).

12. Some States which support a form other than general conditions give reasons for opposing general conditions. General conditions forming part of a contract are invalid when they conflict with mandatory provisions of the applicable law regulating a liquidated damages or penalty clause (Argentina, Japan, Philippines, Poland). Parties might not choose to incorporate the general conditions in their contracts (Argentina).

PART II. COMMENTS ON SPECIFIC ARTICLES

A. Draft Convention, article A, paragraph (1)

13. Austria proposes that the draft Convention should apply in the same circumstances that the United Nations Convention on Contracts for the International Sale of Goods (hereinafter referred to as the "Sales Convention") and the Convention on the Limitation Period in the International Sale of Goods as amended by the Protocol of 1980 apply i.e. when, at the time of the conclusion of the contract the parties have their places of business in different Contracting States, or when the rules of private international law lead to the application of the law of a Contracting State. Liquidated damages and penalty clauses are often contained in international sales contracts, and such harmonization would prevent disparity in the application of the three instruments to such contracts. Furthermore, if this draft article were so modified, the draft Convention would have a wider application.

B. Draft Model Law, article A, paragraph (1)

14. Austria notes that the application of the draft Model Law needs clarification in the following case: when the forum State has adopted the draft Model Law, but its rules of private international law lead, not to the application of its national law, but to the application of the law of another State which has adopted the draft Model Law. Austria proposes that the draft Model Law should apply in such a case, and that to achieve this purpose paragraph (1) (b) should be modified to read: "when the rules of private international law lead to the application of the law of a State adopting the model law".

15. Spain draws attention to the possibility that the parties may have their places of business in different States, only one of which has adopted the draft Model Law. It notes that the draft article does not clarify if the draft Model Law is to apply when the forum is in the State which has not adopted the draft Model Law.

16. Spain also notes that clarification is needed in that the present drafting of paragraph (1) might suggest that the mere fact that at the time of the conclusion of the contract the parties have their places of business in different States (i.e. only the conditions in subparagraph (a) are satisfied) makes the draft Model Law applicable. However, the draft Model Law would not apply in such circumstances if neither of the States had adopted it.

17. Spain accordingly proposes the following text, which would resolve its concerns set forth in the preceding two paragraphs:

> "(1) This law applies to contracts in which the parties have agreed in writing that, upon a total or partial failure of performance by one of them (the obligor), another party (the obligee) is entitled to recover, or to withhold and appropriate, an agreed sum of money, provided that:
>
> "(a) The contract in question is an international one, in the sense that the parties have their places of business in different States at the time of conclusion of the contract, and
>
> "(b) The Model Law has been adopted by both the States, or if by only one, the rules of private international law impose its application to the contract in any event." 3/

C. Draft Convention and draft Model Law, article A, paragraph (1)

18. Some States (Republic of Korea, Spain 4/, USSR) support retention of the requirement that the agreement of the parties should be in writing. Spain notes that writing appears to be required by its commercial code for the validity of international trade contracts. The Republic of Korea notes that the term writing should cover a clause in the contract itself, or a separate agreement signed by the parties, or an exchange of letters or telegrams. Austria supports the solution adopted in articles 11 and 96 of the Sales Convention in regard to

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3/ This text submitted by Spain also incorporates certain suggestions by Spain on other issues: see paras. 18 and 19 below.

4/ See text set forth in para. 17 above.

the requirement of writing if the form of a convention is adopted. 5/

19. Spain notes that the term "forfeit" 6/ does not appear to be very appropriate in the context of this article, because of the associations of this word with public law. More appropriate are the following words or phrases: "retain", "appropriate", "possess himself of" or "withhold payment or reimbursement". 7/

20. The Republic of Korea notes that when a sum additional to the agreed sum becomes payable under an acceleration clause, 8/ such additional sum should be regarded as an agreed sum under this article.

21. UNIDO notes that the uniform rules do not deal with clauses providing an incentive (agreed sum as bonus) for performance before the due date. UNIDO also notes that a liquidated damages or penalty clause may not in all circumstances be an adequate remedy for physical or non-physical damage caused by breach of contract.

D. Draft Convention and draft Model Law, article A, paragraph (3), and article C

22. Spain notes that although article A, paragraph (3) states, inter alia that neither the civil nor commercial character of the contract is to be taken into consideration in determining the application of the Convention or model law, yet article C excludes non-commercial contracts from their application. Accordingly, Spain suggests that, while article C can remain unchanged, article A, paragraph (3) should be modified to read as follows:

> "(3) Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of this law, except as provided in article C." 9/

5/ Article 11 is as follows:

"A contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses."

Article 96 is as follows:

"A Contracting State whose legislation requires contracts of sale to be concluded in or evidenced by writing may at any time make a declaration in accordance with article 12 that any provision of article 11, article 29, or Part II of this Convention, that allows a contract of sale or its modification or termination by agreement or any offer, acceptance, or other indication of intention to be made in any form other than in writing, does not apply where any party has his place of business in that State."

6/ In Spanish "confiscar". This term is also used in articles D, E and F.

7/ In Spanish, "retener", "apropiarse", "hacer suya" or "dejar de pagar o reembolsar". See text set forth in para.17 above.

8/ See A/CN.9/218, para. 22.

9/ This proposal is drafted with reference to a model law, which Spain supports.

23. UNCTAD notes that it may be advisable to clarify in the uniform rules that they do not apply to maritime transport contracts in view of the special nature of maritime transport. However, if it is felt desirable to cover maritime transport contracts, then careful consideration would have to be given to ensure consonance of the uniform rules with maritime law and practice e.g. in matters of demurrage under charterparties. Furthermore, UNCTAD submits that, in the latter case, before any uniform rules are finalized by UNCITRAL the subject should be co-ordinated with UNCTAD with a view to appropriate future action.

E. Draft Convention and draft Model Law, article D

24. Sweden suggests that because of this article, there may be difficulty in applying the uniform rules to cases where the agreed sum is to be claimed from a bank under a first demand guarantee. Under such a guarantee the bank is bound to pay on demand of the obligee without inquiry as to the obligor's liability. The mere fact that the parties agree that that sum is to be claimed under a first demand guarantee may not amount to an agreement that the obligee is entitled to recover the agreed sum even if the obligor is not liable for his failure of performance. Accordingly, the question whether the uniform rules should cover such cases requires consideration.

25. Spain notes that this article may be superfluous, as the principle embodied therein is found in its civil code. 10/ It also notes that, under its civil code 11/, the nullity of the main obligation entails the nullity of the liquidated damages or penalty clause. 12/

F. Draft Convention and draft Model Law, article E, paragraphs (1) and (2)

26. Sweden notes that the remedies of the obligee differ depending on whether the breach of contract by the obligor is delay in performance (paragraph (1)) or non-performance (paragraph (2)). However, it may be impossible to determine whether the breach is delay or non-performance until the delay has lasted so long that it is evident that performance will never take place.

27. The Republic of Korea observes that there is no justification for making the rights of the obligee differ depending on whether the breach of contract by the obligor is delay in performance on the one hand (paragraph (1)), or non-performance or defective performance other than delay on the other (paragraph (2)). In all cases the obligee should be entitled to select his remedy.

28. As regards an agreed sum to be recoverable or forfeited on defective performance other than delay (paragraph (2)) the USSR suggests that it will be useful to specify that when the obligee elects to require performance (rather than claim the agreed sum), he retains the right to the recovery of losses sustained as a result of the defective performance.

10/ Article 1.105

11/ Article 1.155

12/ See A/CN.9/218, para. 38.

29. Spain notes that paragraph (2) must deal with the following four cases:

(a) When the agreed sum is fixed with a view to covering non-performance, and non-performance occurs;

(b) When the agreed sum is fixed with a view to covering defective performance, and defective performance occurs;

(c) When the agreed sum is fixed with a view to covering non-performance, but defective performance occurs; and

(d) When the agreed sum is fixed with a view to covering defective performance, but non-performance occurs.

30. As regards case (a), Spain approves of the solution adopted in paragraph (2). As regards case (b), it observes that the proper solution (although not explicitly stated in the paragraph) is that the obligee should be entitled to recover or forfeit the agreed sum as a supplement to the defective performance he has received. As regards case (c), it notes that it is logical to suppose that the agreed amount would exceed the losses suffered by the obligee from the defective performance. To permit recovery of the agreed sum in full in such a case would be contrary to "economic public order", and accordingly Spain proposes an amendment to article G to deal with this case. 13/ As regards case (d), article F would apply, as contemplated in the commentary 14/, and the obligee's rights would be supplemented by the right to damages given by that article.

G. Draft Convention and draft Model Law, article F

31. Sweden notes that in this article the principle that it is justifiable in certain circumstances to recover damages in addition to the agreed sum is accepted. However, such recovery of damages deprives the agreement of certainty as to the recoverable sum. Assuming, however, that this principle is to be accepted, Sweden observes that the circumstances specified in the article as justifying such recovery are too restricted. Other circumstances (e.g. gross negligence on the part of the obligor) should also be relevant.

32. The Republic of Korea notes that, while under article G, paragraph (2), only a court or arbitral tribunal can vary the agreement of the parties on the amount recoverable, article F might be construed as giving the obligee the power to vary the amount recoverable. If this construction is correct, article F should be modified, as the obligee should not have the power of unilateral variation.

H. Draft Convention and draft Model Law, article G

33. Sweden notes that in paragraph (2) of this article the principle that it is justifiable to reduce the agreed sum in certain circumstances is accepted. However, the circumstances regarded therein as justifying a reduction are too restricted. All the circumstances relating to the contract, including both the circumstances at the time of conclusion of the contract and at a later stage, should be taken into consideration.

13/ See para. 35 below.

14/ See A/CN.9/218, para. 44.

34. Argentina observes that the principle contained in paragraph (1) is important for preserving certainty in international trade transactions. Accordingly, paragraph (2), which contains an exception to that principle, should be construed restrictively. Reduction of the agreed sum should only be permitted when the disproportion between the loss suffered by the obligee and the agreed sum is such that by recovering the agreed sum the obligee will obtain an obvious, unequivocal and clearly disproportionate advantage without any justifying cause.

35. In order to give effect to its suggestion in regard to article E, 15/ Spain suggests that article G should be re-drafted as follows:

"(1) The agreed sum shall not be reduced by a court or arbitral tribunal except as provided in the following paragraph.

(2) The agreed sum may be reduced if it is shown to be grossly disproportionate in relation to the loss that has been suffered by the obligee, and if the agreed sum cannot reasonably be regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee. Specifically, it can be reduced when, after it has been fixed in contemplation of (total) non-performance, defective performance other than delay occurs."

15/ See para. 30 above.