

I. INTERNATIONAL CONTRACT PRACTICES*

A. Report of the Working Group on International Contract Practices on the work of its second session (New York, 13-17 April 1981) (A/CN.9/197)**

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* For consideration by the Commission see Report, chapter III (part one, A, above).

** 8 May 1981. Referred to in Report, para. 38 (part one, A, above). See also Note by the Secretariat: alternative methods for the final adoption of conventions emanating from the work of the Commission (A/CN.9/204), reproduced in this volume, part two, VIII.

Introduction

1. At its twelfth session, the United Nations Commission on International Trade Law decided that work should be undertaken directed to the formulation of uniform rules regulating liquidated damages and penalty clauses, and that the work should be entrusted to the Working Group on International Contract Practices, and requested the Working Group to consider the feasibility of formulating uniform rules on liquidated damages and penalty clauses applicable to a wide range of international trade contracts.¹

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

3. The Working Group held its first session at Vienna, from 24 to 28 September 1979. At the conclusion of that session the Working Group decided that further work by the Working Group on the subject of liquidated damages and penalty clauses was justified, and recom-

mended to the Commission the holding of a further session of the Working Group.² This recommendation was adopted by the Commission at its thirteenth session.³

4. The Working Group held its second session at United Nations Headquarters from 13 to 17 April 1981. All the members of the Working Group were represented except Ghana, Guatemala and Sierra Leone.

5. The session was attended by observers from the following States members of the Commission: Australia, Cuba, German Democratic Republic, Nigeria and Yugoslavia.

6. The session was also attended by observers from the following Member States of the United Nations: Canada, El Salvador, Gabon, Greece, Malaysia, Niger, Thailand and Uruguay.

7. The session was attended by an observer from the following United Nations organ: United Nations Industrial Development Organization.

8. The session was attended by an observer from the following international non-governmental organization: International Chamber of Commerce.

² Report of the Working Group on the work of its first session (A/CN.9/177, para. 43) (Yearbook . . . 1980, part two, II).

³ Report of the United Nations Commission on International Trade Law on the work of its thirteenth session (1980), *Official Records of the General Assembly, Thirty-fifth Session, Supplement No. 17* (A/35/17), para. 16 (Yearbook . . . 1980, part one, II, A).

¹ Report of the United Nations Commission on International Trade Law on the work of its twelfth session (1979), *Official Records of the General Assembly, Thirty-fourth Session, Supplement No. 17* (A/34/17), para. 31 (Yearbook . . . 1979, part one, II, A).

9. The Working Group elected the following officers:

Chairman: Mr. I. Tarko (Austria)
Rapporteur: Mr. M. Cuker (Czechoslovakia)

10. The following documents were placed before the Working Group:

(a) Report of the Secretary-General entitled "Liquidated damages and penalty clauses (I)" (A/CN.9/161);*

(b) Report of the Working Group on International Contract Practices on the work of its first session (A/CN.9/177);**

(c) Report of the Secretary-General entitled "Liquidated damages and penalty clauses (II)" (A/CN.9/WG.2/WP.33 and Add.1);***

(d) Provisional agenda for the session (A/CN.9/WG.2/WP.32).

11. The Working Group adopted the following agenda:

(a) Election of officers.

(b) Adoption of the agenda.

(c) Consideration of the feasibility of formulating uniform rules on liquidated damages and penalty clauses applicable to a wide range of international trade contracts.

(d) Other business.

(e) Adoption of the report.

Consideration of revised draft rules submitted by the Secretariat

12. The Working Group decided to examine the revised draft rules on liquidated damages and penalty clauses submitted by the Secretariat.⁴

SCOPE OF APPLICATION

Revised draft rule 1

13. Revised draft rule 1 as considered by the Working Group is as follows:

"These rules apply to a contract in which the parties have agreed [in writing] that, upon a total or partial failure of performance by a party (the debtor), another party (the creditor) is entitled to recover, or to forfeit, an agreed sum of money."

14. The Working Group was of the view that the formulation of this draft rule would depend on a decision to be taken as to the form the uniform rules might take

(convention, model law or model clauses). Accordingly, the Working Group decided to defer consideration of revised draft rule 1 until the conclusion of its deliberations on the other draft rules.

REGULATION OF THE CONTRACT BY THE RULES

Revised draft rule 2

15. Revised draft rule 2 as considered by the Working Group is as follows:

"Unless the parties have agreed otherwise, the creditor is not entitled to recovery or forfeiture of the agreed sum if the debtor is not liable for the failure of performance."

16. The Working Group adopted revised draft rule 2.

17. It was decided that in the English version of the rules, the terms "creditor" and "debtor" should be replaced by the terms "obligee" and "obligor" respectively.

18. One representative expressed the view that the phrase "not liable for the failure of performance" needed clarification.

Revised draft rule 3

19. Revised draft rule 3 as considered by the Working Group is as follows:

"1. When the agreed sum is intended by the parties to be complete compensation for the loss caused by a failure of performance, the creditor cannot enforce performance if he enforces recovery or forfeiture, of the agreed sum.

"2. When the agreed sum is intended by the parties to compensate the creditor for the loss caused in the period between a failure of performance and the time when proper performance is rendered, the creditor may enforce performance, and also enforce recovery, or forfeiture, of the agreed sum.

"3. Parties may by agreement provide otherwise."

20. There was wide agreement that the reference to the intention of the parties in the formulation of paragraphs (1) and (2) was undesirable. There was uncertainty as to the criteria for determining the intention of the parties, and furthermore in the case of certain contracts, the intention of the parties may not be ascertainable from the contracts. A formulation referring only to the agreement of the parties was preferable.

21. The view was expressed that both paragraphs (1) and (2) implied that in certain circumstances the obligee was entitled to enforce performance. However, under some legal systems the remedy of enforcement of performance was not normally available. It was agreed that

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

** Yearbook . . . 1980, part two, II.

*** Reproduced in this volume, part two, I, B, I and 2.

⁴ The revised draft rules are set forth in document A/CN.9/WG.2/WP.33, Part IV (reproduced in this volume, part two, I, B, I).

there should be clarification that enforcement of performance was available only when the applicable legal system granted such enforcement.

22. It was suggested that the issue of the combination of possible remedies dealt with by this revised draft rule might be resolved by reference to the distinction between total and partial failure of performance. In case of total failure, the obligee should only be entitled to enforce either performance of the main obligation or recovery of the agreed sum. In case of partial failure, the obligee should be entitled to enforce both performance and recovery of the agreed sum. It was noted, however, that in certain cases there may be difficulty in distinguishing between total and partial performance.

23. It was observed that it would be preferable not to use the term compensation in this revised draft rule. The relationship between the right to compensation and the right to the agreed sum was regulated, not in this draft rule, but in draft rule 5.

24. After deliberation, the Working Group requested the Secretariat to submit two alternative re-drafts of revised draft rule 3 on the following lines. The first alternative should set forth as a main rule that the obligee was entitled both to performance and recovery of the agreed sum, save in exceptional cases to be specified. The second alternative should set forth as a main rule that the obligee was only entitled either to performance or to recovery of the agreed sum, save in exceptional cases to be specified.

25. The Secretariat submitted to the Working Group the following alternatives:

Alternative A

"1. By claiming the agreed sum, the obligee does not lose his right to performance, unless:

"(a) The parties have agreed otherwise, or

"(b) He recovers the agreed sum which can reasonably be regarded as a substitute for performance.

"2. By claiming performance, the obligee does not lose his right to the agreed sum, unless:

"(a) The parties have agreed otherwise, or

"(b) He obtains performance, and the agreed sum can reasonably be regarded as a substitute for performance."

Alternative B

"By recovering the agreed sum, the obligee loses his right to performance, and by obtaining performance, the obligee loses his right to the agreed sum, unless:

"(a) The parties have agreed otherwise, or

"(b) The agreed sum cannot reasonably be regarded as a substitute for performance."

26. Support was expressed for each of the above alternatives. In support of alternative A, it was noted that in international contract practice, liquidated damages and penalties were most often provided for delay in performance, and that the main rule provided in this alternative was the rule generally applied in such cases. It was also noted that the main rule in this alternative supported the right to obtain performance, which was the principal right under a contract.

27. In support of alternative B, it was noted that this led to results which were fair to both parties.

28. It was observed that the significant difference between the two alternatives was in the different allocation of the burden of proof between the obligor and obligee.

29. During the consideration of the above two alternatives, one representative submitted the text of a proposed draft rule 3 to the Working Group, and this text was referred by the Working Group for consideration by a drafting party. The draft of the drafting party was adopted by the Working Group subject to a minor modification, and is as follows:

"1. Where the agreed sum is recoverable, or subject to forfeiture, on delay in performance of the obligation, the obligee is entitled to both performance of the obligation and the agreed sum.

"2. Where the agreed sum is recoverable, or subject to forfeiture, on non-performance, or defective performance other than delay, the obligee can obtain either performance, or recovery or forfeiture of the agreed sum, unless the agreed sum cannot reasonably be regarded as a substitute for performance.

"3. The rules set forth above shall not prejudice any contrary agreement made by the parties."

30. One representative observed that cases had occurred where contracts provided for the payment of agreed sums for non-acceptance of goods. Suppliers had then concentrated their deliveries so that it was physically impossible for the buyers to accept the goods, and thereafter had sought to recover the agreed sums. It was stated in reply that this difficulty might be resolved under proposed draft rule 6 dealing with the reduction of the agreed sum, or by reference to draft rule 2, under which the buyer may not be liable for non-acceptance in such circumstances.

Revised draft rule 5

31. Revised draft rule 5 as considered by the Working Group is as follows:

"If a failure of performance in respect of which parties have agreed that a sum of money is to be recoverable, or forfeited, occurs, the creditor is only entitled to recover, or forfeit, the sum, and is not entitled to damages. Parties may agree that the creditor, if he

proves that his loss exceeds the amount of such sum, may also recover the amount of the excess.”

32. The Working Group was of the view that parties should be given the power to modify any aspect of the rule by agreement.

33. Opinion was divided on the merits of the draft rule. The view was expressed that it would be preferable to delete the second sentence of the rule, because such a deletion would simplify the rule and reduce the prospects of litigation. On the other hand, it was stated that fairness to the creditor required that he be entitled, where his loss exceeded the agreed sum, to recover in addition to the agreed sum, damages in the amount of such excess, irrespective of an agreement between the parties. According to one view, this was the rule prevalent in current international contract practice.

34. After deliberation, the Working Group requested the Secretariat to submit to the Working Group alternative drafts reflecting the different views expressed.

35. The Secretariat submitted the following alternative drafts:

Alternative A

“Unless the parties have agreed otherwise, if a failure of performance in respect of which the parties have agreed that a sum of money is to be recoverable, or forfeited, occurs, the creditor is entitled to recover, or forfeit, the sum and is not entitled to damages.”

Alternative B

“Unless the parties have agreed otherwise, if a failure of performance in respect of which the parties have agreed that a sum of money is to be recoverable, or forfeited, occurs, the creditor is entitled to recover, or forfeit the sum and is entitled to damages to the extent that he proves that his loss exceeds the agreed sum.”

36. Support was expressed for each of the above alternatives for the reasons set forth in paragraph 33 above.

37. The view was also expressed that, in certain situations, there was uncertainty when alternative A above was considered in relation to draft rule 3. Under draft rule 3, the creditor who chose to enforce performance might lose his right to the agreed sum. If, for any reason, he then failed to obtain performance, he may be left with no remedy, as alternative A above excluded his right to damages. It was proposed that the difficulty might be resolved by adding in alternative A the words “in respect of this failure” after the word “entitled”, and the Working Group adopted this proposal. It was noted that if alternative B was adopted, the same modification should be made.

38. It was observed that the appropriate rule to be adopted under draft rule 5 might depend on a decision on

the rule to be adopted in draft rule 6 regulating the possible variation of the agreed sum, and the Working Group accordingly considered revised draft rule 6, without taking a final decision on the formulation of draft rule 5.

Revised draft rule 6

39. Revised draft rule 6 as considered by the Working Group is as follows:

Variant 1

“The agreed sum shall neither be increased nor reduced.”

Variant 2

“The agreed sum specified may be reduced when it is [manifestly] [grossly] excessive [in relation to the loss which has occurred], but only if such sum did not constitute a genuine pre-estimate by the parties of the loss likely to be suffered by the creditor.”

Variant 3

“An agreement of the kind described in Rule 1 above shall be void if the agreed sum is [manifestly] [grossly] excessive in relationship to both (a) the loss that could reasonably have been anticipated from the failure of performance, and (b) the actual loss caused thereby. The agreement shall not be void if the loss could not have been precisely predicted or cannot be precisely established.”

40. There was little support for variant 1 as an exclusive rule. However, it was proposed that the principle stated in variant 1 might be combined with some of the rules contained in variant 2 to produce an acceptable result. Accordingly, the Working Group requested the Secretariat to submit an alternative draft of rule 6. Combining the two variants, the Secretariat submitted the following alternative draft on the assumption that alternative A of the Secretariat draft of rule 5 (para. 35 above) would be adopted.

“1. The agreed sum shall neither be increased nor reduced.

“2. However, the agreed sum may either be increased or reduced if it is grossly disproportionate in relation to the loss which has occurred.

“[3. The rule in paragraph 2 may be invoked only in cases where 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.]”

41. It was observed that paragraph 2 of this draft made the increase and reduction of the agreed sum dependent on the same condition. However, in relation to increase, account had to be taken of the consideration that the agreed sum was often intended to be a limitation on liability, and therefore not intended to be subject to

increase. Increase and decrease should therefore be treated differently. It was also suggested that the disproportion referred to in paragraph 2 should be judged, not by relating the agreed sum to the loss which had occurred, but by relating it to a genuine and reasonable pre-estimate to be made at the time of concluding the contract.

42. The Secretariat therefore submitted a further draft of rules 5 and 6, taking into account the deliberations in the Working Group. This draft was adopted by the Working Group, subject to certain modifications, and is as follows:

Rule 5

“Unless the parties have agreed otherwise, if a failure of performance in respect of which the parties have agreed that a sum of money is to be recoverable or forfeited occurs, the creditor is entitled, in respect of the failure, to recover or forfeit the sum, and is entitled to damages to the extent of the loss not covered by the agreed sum, but only if he can prove that his loss grossly exceeds the agreed sum.”

Rule 6

“(1) The agreed sum shall not be reduced by a court or arbitral tribunal.

“(2) However, 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.”

43. It was noted that where parties had agreed that the specified sum was to serve as a limitation of liability, the opening phrase of rule 5 (“unless the parties have agreed otherwise,”) would prevent the recovery of damages in addition to the agreed sum. However, two representatives expressed the view that this opening phrase might not achieve this result, and that the rule might produce unexpected results, and that a different wording was required.

44. It was noted that in the French version of these rules the word “grossly” should be rendered by the word “manifestement”.

SCOPE OF APPLICATION

Revised draft rule 1

45. After concluding its deliberations on draft rules 2 to 6, the Working Group resumed its consideration of draft rule 1 and considered the form that the uniform rules might take.

46. The Working Group decided that the issue of

form should be left for decision by the Commission. In this connexion, the Secretary of the Commission stated that the Secretariat would place before the fourteenth session of the Commission a study examining the range of possible approaches which the Commission might undertake, and that the issue of the form of the rules might be decided after a consideration of that study. One representative stated that the business community in his country was of the view that it would not be useful to cast the uniform rules in the form of rules of law.

47. The Working Group noted that the present formulation of draft rule 1 did not deal with (a) definition of the circumstances which would make a contract qualify as international; and (b) whether any types of contract are to be excluded from the scope of the rules and if so, how this should be done.

48. The Working Group was of the view that, if the rules were to take the form of a convention, some additional provisions would be required to resolve these issues in an appropriate manner. The Secretariat might be requested to draft such additional rules.

49. The question was raised as to the scope of the entitlement to forfeit an agreed sum of money given to the obligee under draft rule 1, and referred to in the other draft rules. It was noted in reply that the entitlement to forfeit included rights given to the obligee by agreement with the obligor in the following cases:

(a) It is agreed between the parties that a sum of money paid by the obligor to the obligee is to be retained (forfeited) by the obligee in the event of failure of performance by the obligor, but returned in the event of proper performance;

(b) It is agreed between the parties that a sum of money due from the obligee to the obligor is to be withheld (forfeited) by the obligee in the event of failure of performance by the obligor, but paid in the event of proper performance.

50. The Working Group provisionally adopted revised draft rule 1, subject to certain modifications, and the draft rule as modified is as follows:

“These rules apply to an international contract in which the parties have agreed [in writing] that, upon a total or partial failure of performance by a party (the obligor), another party (the obligee) is entitled to recover, or to forfeit, an agreed sum of money.”

Other matters

51. The Working Group requested the Secretariat to examine the draft rules adopted by the Working Group to ensure consistency in terminology, and to reproduce in an annex to this report the text of the draft rules as revised.

ANNEX

Draft rules on liquidated damages and penalty clauses adopted by the Working Group^a

SCOPE OF APPLICATION

Draft rule 1

"These rules apply to an international contract in which the parties have agreed [in writing] that, upon a total or partial failure of performance by a party (the obligor), another party (the obligee) is entitled to recover, or to forfeit, an agreed sum of money."^b

Draft rule 2

"Unless the parties have agreed otherwise, the obligee is not entitled to recover or to forfeit the agreed sum if the obligor is not liable for the failure of performance."

REGULATION OF THE CONTRACT BY THE RULES

Draft rule 3

"1. Where the agreed sum is to be recoverable or forfeited on delay in performance of the obligation, the obligee is entitled to both performance of the obligation and the agreed sum.

"2. Where the agreed sum is to be recoverable or forfeited on non-performance, or defective performance other than delay, the obligee is

^a Changes have been made in the text of draft rules 2, 3 and 4 to ensure consistency in terminology.
^b For additional provisions which might be required, see para. 48 above.

entitled either to performance, or to recover or forfeit the agreed sum, unless the agreed sum cannot reasonably be regarded as a substitute for performance.

"3. The rules set forth above shall not prejudice any contrary agreement made by the parties."

Draft rule 5^c

"Unless the parties have agreed otherwise, if a failure of performance in respect of which the parties have agreed that a sum of money is to be recoverable or forfeited occurs, the obligee is entitled, in respect of the failure, to recover or forfeit the sum, and is entitled to damages to the extent of the loss not covered by the agreed sum, but only if he can prove that his loss grossly exceeds the agreed sum."

Draft rule 6

"1. The agreed sum shall not be reduced by a court or arbitral tribunal.

"2. However, 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."

^c Draft rule 4 submitted by the Secretariat to the first session of the Working Group was deleted by the Working Group at that session. No rule 4 was included in the revised draft rules submitted to the second session of the Working Group. In order to facilitate comparison with the draft rules submitted to the first session, the numbering of revised draft rules 5 and 6, which correspond to draft rules 5 and 6 submitted to the first session, have been retained.

B. Working Paper submitted to the Working Group on International Contract Practices at its second session (New York, 13-17 April 1981)

1. REPORT OF THE SECRETARY-GENERAL: LIQUIDATED DAMAGES AND PENALTY CLAUSES (II) (A/CN.9/WG.2/WP.33)*

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* 12 February 1981.