

The UNIDROIT Principles of International Commercial Contracts: What Do They Mean for Australia?

Comment

The case of long-term, relational contracts

Donald Robertson

Partner, Freehills,
Adjunct Professor of Law, Sydney Law School

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Relational contracts

- 1 The UNIDROIT Principles of International Commercial Contracts have made a surprisingly quick impact upon contract law globally. Professor Bonell has documented the immediate success of the UNIDROIT Principles.¹ They are in the form of a 'restatement', as if a code. However, they must inevitably develop the accretions of a common law system of reasoning as they have gaps which must be filled and contain concepts that require interpretation.
- 2 The UNIDROIT Principles are a truly impressive exercise in reducing the core principles of contract law to writing – a new *lex mercatoria*. The great bulk of these principles are uncontroversial and, as the UNIDROIT Principles demonstrate, there is a good deal of commonality between the common law and civil legal worlds in this respect.
- 3 The UNIDROIT Principles are therefore having an influence in many jurisdictions, not just European jurisdictions, with which Australian business is engaging in commerce.
- 4 They will become more important if the vision of the Rudd Government is achieved. The Commonwealth Attorney-General has said that it is the view of the Rudd Government 'that we should promote the Federal Court as the regional hub for commercial litigation.'²
- 5 If this vision is to become a reality, commercial parties should consider adopting a system of law that governs their contractual relationships that will be acceptable to non-Australian entities. The UNIDROIT Principles are an obvious choice.
- 6 Whether the UNIDROIT Principles continue to have influence will depend on whether they make sense to commercial people. This primarily means that they promote contractual certainty. They should also confine themselves to the core workings of contract law and not stray into territory that is better left to tort law, equity or restitution law.
- 7 A key test is whether the principles deal adequately with 'relational contracts'. In the commercial world this is the typical contract.

¹ Michael Joachim Bonell, 'UNIDROIT Principles 2004 – The New Edition of the Principles of International Commercial Contracts adopted by the International Institute for the Unification of Private Law' (2004-1) *Uniform Law Review* 5.

² The Attorney-General, The Hon Robert McClelland, *Australian Financial Review Legal Conference 2008*, 17 June 2008.

'Much economic activity takes place within long-term, complex, perhaps multiparty contractual (or contract-like) relationships; behavior is, in varying degrees, sheltered from market forces.'³

8 Relational contracts understand contracts as providing a 'framework' for transient and more permanent relationships and a 'norm of ultimate appeal when relations cease in fact to work'. Contracts are one of the central institutions of capitalism.⁴ However, all contracts – but especially long-term contracts – are necessarily incomplete (unforeseen events are inevitable) and parties have a degree of 'discretion' in relation to how they perform their contractual obligations,⁵ which obligations can be 'evolutionary' in nature.⁶

9 The presence of *discretion* in the performance of contractual obligations gives rise to particular legal challenges more like those found in public law. Finn J has stated that special rules should not apply to such contracts, but 'particular rules of contract law have greater or less ease of application in relational contract settings'.⁷ There are 4 areas to which attention needs to be paid.

10 First, as Finn J also notes, there is a need, in relational contracts of significant duration, to adjust terms to accommodate changed or unforeseen circumstances.⁸

11 Second, we need to work out whether we have a preference for keeping the contract alive or terminating it. The common law, by means of the relatively blunt doctrine of frustration, struggles (often unsuccessfully) to preserve contractual relationships. In relational contracts, on the other hand, the preservation of the relationship is at the forefront. The preference for preserving the relationship explains the rules found in the UNIDROIT Principles for rules that aim to save rather than terminate the contract. This is an unusual stance for a lawyer in the Anglo-Australian tradition who is used to advising on questions of breach and the ability to terminate a contract. Specific performance, not damages, might now be seen to be the primary remedy.

12 Third, the presence of discretion within the parties to the contract requires us to grapple with questions of fault: duties of good faith and cooperation, best efforts responsibilities, reasonableness and duties of care and loyalty are intended to deal with opportunistic behaviour.⁹ Many of the provisions dealing with relational contracts use the language of fault.

13 Fourth, more attention needs to be paid to contractual mechanisms for dealing with risk in relation to supervening events (including by way of silence). These mechanisms are hardly mentioned in most texts and rarely taught to students. Yet the devices are pervasive.

'The risk of supervening events, including changes in the law, can be allocated by the parties in the agreement. The risk allocation devices or terms used include express conditions, pricing provisions with escalation clauses, force

³ Victor Goldberg, 'Relational Exchange: Economics and Complex Contracts' in Victor P Goldberg (ed), *Readings in the economics of contract law* (Cambridge University Press, 1989), 16. Long-term contracts include not only contracts with lengthy periods of duration, but those which are operated on a continuing though indefinite period and terminable at short-notice.

⁴ Karl Llewellyn, 'What Price Contract? An Essay in Perspective' 40 *Yale Law Journal* 704 (1931). The seminal economic work is that of Oliver E Williamson, *The Economic Institutions of Capitalism* (Free Press, New York, 1985). An overview of the 'new institutional economics' which considers the role that 'contract' plays in private ordering is found in Eirik G Furubotn and Rudolf Richter, *Institutions & Economic Theory* (University of Michigan Press, 2nd ed, 2005), chapter 4.

⁵ Victor P Goldberg, 'Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith' 35 *UC Davis Law Review* 319 (2002).

⁶ *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1 at [220].

⁷ *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1 at [224].

⁸ *GEC Marconi Systems Pty Ltd v BHP Information Technology Pty Ltd* (2003) 128 FCR 1 at [230].

⁹ George M Cohen, 'The Fault that Lies within Our Contract Law', *University of Virginia Law School, The John M Olin Program in Law and Economics Working Paper Series*, Paper 46 (2008).

majeure clauses, tailor-made terms aimed at particular events, and flexible quantity terms, such as requirements or output contracts. In addition, there are situations where the contract is silent but the promisor assumes the risk because it was actually foreseen or discussed in the pre-contract bargaining and not allocated by the agreement. Silence in the light of events foreshadowed at the time of contracting is, in effect, tacit risk allocation.¹⁰

Provisions relevant to excuse

UNIDROIT Principles

- 14 The UNIDROIT Principles have some important, and in some cases 'radical' (to an Anglo-Australian lawyer)¹¹ provisions in relation to these matters.

Article 6.2 Hardship

- 15 Even where performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations (Article 6.2.1). That much is orthodox. However, this rule is made subject to the presence of hardship.
- 16 Hardship is defined in Article 6.2.2.
- 'There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance has diminished, and
- (a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
- (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
- (c) the events are beyond the control of the disadvantaged party; and
- (d) the risk of the events was not assumed by the disadvantaged party.'
- 17 It may be that this restates a form of frustration of purpose, although it is probably wider than that doctrine is currently understood. The language of this clause will strike an Australian lawyer as curious e.g. 'equilibrium of the contract'. It does not mean 'fairness'; nor 'equality'. It requires an understanding of the purpose and intended effect of the contract on risk and reward. However, the language is perhaps no more curious than the ill-adapted language of 'frustration', which struggles to encompass several possible concepts – frustration of purpose, impossibility and impracticability.
- 18 The sting comes in the remedial provisions in Article 6.2.3.
- Reflecting the interest in keeping the transaction alive, the disadvantaged party is entitled to request renegotiation of the contract – the request must be made without undue delay and stating the grounds upon which it is based. That request does not itself entitle the party to withhold performance.
- The negotiations are subject to the obligation of good faith in Articles 1.7 and 2.1.15 and cooperation (Article 5.1.3).
- Upon failure to reach agreement the parties can resort to court. The court may, if reasonable:

¹⁰ Richard E Speidel, *Contracts in Crises: Excuse Doctrine and Retrospective Government Acts* (Carolina Academic Press, 2007), 193-194.

¹¹ Roy Goode, 'International Restatements of Contract and English Contract Law' (1997) 2 *Uniform Law Review* 231 at 243.

- terminate the contract (at a date and time to be fixed – note the difference to the doctrine of frustration) or
- ‘adapt’ the contract with a view to restoring its equilibrium.

19 The power to adapt (reformulate or adjust) contracts will always be controversial. It has been used only once in the US. There is one only case where the court actually reformed the contract, but there is clearly power to do so and other cases have considered the circumstances in which that power might be exercised.¹²

Article 7.1.7 Force majeure

20 This Article contains a restatement of the force majeure doctrine. An excuse is given for non-performance if:

- it was due to an impediment beyond the control of the contracting party;
- the contracting party could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

21 There is nothing controversial about these terms, but there are many gaps in the provisions and they will need to be supplemented by contractual provisions for particular sorts of contracts, e.g. provisions in relation to make up of undelivered product due to the force majeure event.

22 The controversial and messy position in relation to what happens by way of restitutionary remedies in both this and hardship is currently being considered.¹³ It can do no worse than the legislative position in Australia.

Other sources of law

23 A useful comparison can be made between the UNIDROIT Principles and other international instruments.

Exemption in Article 79 – CISG

24 This Article contains an excuse for performance so long as the failure can be proved to be due to an ‘impediment’ beyond the contracting party’s control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

25 This provision is closer to a force majeure provision. It does not provide for court adjustment of the contract. It shields the party from a damages claim but leaves all other remedies intact.¹⁴

Impracticability

26 The US Uniform Commercial Code deals with these circumstances in a different manner. In *UCC § 2-615 – Excuse for failure of presupposed conditions*, except so far as a seller has assumed a greater obligation, delay in performance in whole or in part, is not a breach of the seller’s duty if performance has become impracticable by the occurrence of

¹² *Aluminum Co of America Essex Group Inc* 499 E Supp 53 (WD Pa, 1980) (relief granted by price clause failed); *Oglebay Norton Co v Armco Inc* 556 NE 2d 515 (Ohio, 1990). See Richard E Speidel, *Contracts in Crises: Excuse Doctrine and Retrospective Government Acts* (Carolina Academic Press, 2007), 231 – 234 who reviews the case law (Professor Speidel is a long-time supporter of the power of adjustment in relational contracts).

¹³ Professor Reinhard Zimmermann, *Draft Chapter on Unwinding Failed Contracts* (Study L – Doc. 105. April 2008).

¹⁴ For a comparison of the UNIDROIT Principles and CISG see John Felemegas (ed), *An International Approach to the Interpretation of the United Nations Convention on Contracts for the International Sale of Goods* (1980) as Uniform Sales Law (Cambridge University Press, 2007), 236-246.

a contingency the non-occurrence of which was a basic assumption of which the contract was made.¹⁵ This clause allows a seller to allocate production and deliveries in any way that is 'fair and reasonable' but requires ('must allocate') sales amongst its customers on a pro-rata basis.¹⁶

27 This is a 'new synthesis' of the development of the law regarding supervening events. It reflects a greater judicial intervention in US contract law than an Australian lawyer is comfortable with. Farnsworth states:

'The new synthesis candidly recognises that the judicial function is to determine whether, in the light of exceptional circumstances, justice requires a departure from the general rule that a promisor bears the risk of increased difficulty of performance.'¹⁷

28 This is a default rule that is often changed by express provisions, e.g. a force majeure clause. The rule has been adapted by the *Restatement Second, Contracts*, §261.

Principles of European Corporate Law

29 The Principles of European Contract Law are prepared by the Commission on European Contract Law. Like the UNIDROIT Principles they are not mandatory in nature and depend for their force on their acceptability to contracting parties (in this case, a class of person wider than commercial entities).

30 The PECL have, not surprisingly, many affinities with the UNIDROIT Principles. They contain similar provisions in relation to:

- Change of Circumstances – Article 6.111: Change of Circumstances.

Like the UNIDROIT Principles, this Article provides for court reformation of the contract. The PECL recognises that, absent such a provision, the parties to a contract might have an incentive to introduce appropriate clauses into their contracts.

'But experience suggests that frequently the parties are not sufficiently sophisticated, or are too careless of their own interests, to do this; or they insert clauses which do not cover every eventuality.'¹⁸

There is no evidence given for this broad-ranging statement. Whatever the truth of this statement in consumer contracting, it seems unlikely to be true in international commercial contracts, where the parties do have an incentive to contract for their commercial needs.

- Impossibility: Article 8.108: Excuse Due to an Impediment

This Article is drafted in similar terms to UNIDROIT Principles 7.1.7.

Possible new directions – termination *for 'just cause'*

31 UNIDROIT are considering adding a new set of provisions in relation to termination of contracts for 'just cause', although these have proved to be controversial.¹⁹

¹⁵ Other relevant provisions of the UCC include the obligation of substituted performance (UCC § 2-614).

¹⁶ Lord Morris of Borth-y-Gest expressed a view that a strong clause would be needed to allow breach of a contract by reference to other commitments: *Hong Guan & Co Limited v R Jumabhoy & Sons Limited* [1960] AC 684 at 700. But see Donaldson J in *Intertradax SA v Lesieur-Tourteaux SARL* [1977] 2 Lloyd's Rep 146 at 155.

¹⁷ E Allan Farnsworth, *Farnsworth on Contracts* (Aspen, 3rd ed, 2004), §9.6.

¹⁸ Ole Lando and Hugh Beale, *Principles of European Contract Law, Parts I and II* (Kluwer, 2000), 323.

- 32 The proposal:
- applies to contracts with a recurring obligation to do something positive (not to abstain from doing something). In some systems of law these are contracts which are characterised as relational contracts;
 - requires notice within a reasonable period of time of becoming aware of;
 - a just cause;
 - does not preclude an action for damages.
- 33 The notion of a just cause is the critical term. The relevant draft states:
- ‘There is a just cause if, having regard to all the circumstances of the specific case and balancing the interests of both parties, the terminating party cannot reasonably be expected to continue the contractual relationship until the agreed termination date or until the end of the notice period.’
- 34 Whilst a lawyer in the Anglo-Australian tradition will probably think first of principles of breach allowing termination, and then of equitable principles, the examples given in the discussion paper are broader:
- the lost of mutual trust between parties to a licensing agreement due to late performance;
 - sudden dramatic diminution of the financial capacity of a lessee;
 - risk of imminent insolvency of a borrower.

Assessment

- 35 As Australian commerce grows more international in nature, there will be a need to find a common ‘framework’ by which contractual relationships are maintained. The UNIDROIT Principles and PECL are obvious sources of rules and institution building in this regard. This creates a fundamentally different legal environment in relation to risk-bearing for supervening events. This is not necessarily a good or bad thing, but it is something with which Australian business should come to grips.
- 36 The case law and literature in Australia about relational contracts is thin. The inclusion into the UNIDROIT Principles of concepts that deal with relational contracts is a challenge to Australian lawyers and courts to grapple with the issues that arise in a relational setting.
- 37 The UNIDROIT Principles will continue to prod us along this direction. However, that effort may stall if commercial parties believe that the rules in the new law merchant are too open-textured, allowing too much judicial intervention in contracting practices.
- 38 The debate about these matters in Australia has barely started. I look forward to the next edition of the UNIDROIT Principles and a healthy debate about the role that they play in commercial contracts in Australia.

¹⁹ Professor François Dessemontet, *Position Paper with Draft Provisions on Termination of Long Term Contracts for Just Cause* (Study L – Doc. 104, January 2007).