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REVISED TEXT OF DRAFT UNIFORM RULES ON
 LIQUIDATED DAMAGES AND PENALTY CLAUSES

Report of the Secretary-General

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INTRODUCTION

1. At its fourteenth session, the Commission considered draft uniform rules on liquidated damages and penalty clauses applicable to a wide range of international trade contracts prepared by its Working Group on International Contract Practices. 1/* At that session, the Commission requested the Secretary-General to incorporate in the draft uniform rules such supplementary provisions as might be required if the rules were to take the form of a convention or model law, and to prepare a commentary on the model law. At its fifteenth session the Commission had before it the uniform rules incorporating such supplementary provisions, together with a commentary thereon. 2/
2. At its fifteenth session, the Commission considered whether the uniform rules should be embodied in a convention, in a model law or in general conditions. The Commission decided to defer a decision on this question till its sixteenth session. 3/
3. The Commission also discussed the substance of articles A, paragraph (1) (the type of clause to be covered in the uniform rules), D, E, F and G of the draft uniform rules. 4/ After its discussion, the Commission referred these articles to a drafting group for consideration in the light of the discussion in the Commission. The drafting group was of the view that it would be unable to complete its work in preparing a revised text of the draft uniform rules in the time available. Accordingly, the Commission decided that the Secretariat should submit a revised text for consideration by the Commission at the sixteenth session, taking into account the discussion at the fifteenth session and within the drafting group. 5/
4. The present document has been prepared in response to that decision. It sets out the draft articles considered at the fifteenth session (headed "previous draft"), and sets out thereunder the corresponding revised draft articles (headed "revised draft"). Two draft articles (articles X and Y) are new articles drafted as a result of the discussions. Explanatory foot-notes to the draft articles are included. In preparing the revised draft, an attempt has been made to reflect most of the suggestions for modification of the rules which received support during the discussions at the fifteenth session. Alternative suggestions are advanced where there was no prevailing view as to the desired modifications. Some suggestions are also made of a purely drafting nature.
5. For convenience of reference, the articles not considered at the fifteenth session (articles A, paragraphs (2) and (3), B and C) are also set out in the present document.

* The texts of foot-notes commence at page 9 below.

THE RULES

PART I: SCOPE OF APPLICATION AND GENERAL PROVISIONS

Article A, paragraph (1)Previous draft (draft convention)

"(1) This Convention applies to contracts in which the parties have agreed in writing 6/ 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 7/ an agreed sum of money when, at the time of the conclusion of the contract, the parties have their places of business in different Contracting States."

Previous draft (draft model law)

"(1) This law applies to contracts in which the parties have agreed in writing 6/ 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 7/ an agreed sum of money:

(a) when, at the time of the conclusion of the contract, the parties have their places of business in different States, and

(b) when the rules of private international law lead to the application of the law of (the State adopting the Model Law)."

Revised draft (draft convention)

"(1) This Convention applies:

(a) to contracts in which the parties have agreed that, upon a total or partial failure of performance by a party (the obligor), the other party 8/ (the obligee) is entitled to recover or to withhold 7/ an agreed sum of money from the obligor, 8/ where such sum is intended as a

pre-estimate of damages, or as a security for performance, or both⁷ ⁷where such sum is intended as a pre-estimate of damages to be paid by the obligor for loss suffered by the obligee as a consequence of that failure, or as a penalty for that failure, or both⁷ ⁹/, and

(b) where, at the time of the conclusion of the contract, the parties have their places of business in different Contracting States ⁷, or where the parties have their places of business in different States and the rules of private international law lead to the application of the law of a Contracting State ¹⁰/⁷.

(1 bis) Except as expressly provided in this Convention, it is not concerned with the validity of the contract or of any of its provisions."¹¹/⁷

Revised draft (draft model law)

"(1) This law applies:

(a) to contracts in which the parties have agreed that, upon a total or partial failure of performance by a party (the obligor), the other party ⁸/ (the obligee) is entitled to ⁷recover or to withhold⁷ ⁷/ an agreed sum of money from the obligor, ⁸/⁷ where such sum is intended as a pre-estimate of damages, or as a security for performance, or both⁷ ⁷where such sum is intended as a pre-estimate of damages to be paid by the obligor for loss suffered by the obligee as a consequence of that failure, or as a penalty for that failure, or both⁷ ⁹/, and

(b) where, at the time of the conclusion of the contract, the parties have their places of business in different States, and the rules of private international law lead to the application of the law of (the State adopting the Model Law).

(1 bis) Except as expressly provided in this law, it is not concerned with the validity of the contract or of any of its provisions." ¹¹/⁷

Article A, paragraphs (2) and (3) ^{12/}

"(2) The fact that the parties have their places of business in different States is to be disregarded whenever this fact does not appear either from the contract or from any dealings between, or from information disclosed by, the parties at any time before or at the conclusion of the contract.

(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 (Convention) (law)."

Article B ^{13/}

"For the purposes of this (Convention) (law):

(1) If a party has more than one place of business, the place of business is that which has the closest relationship to the contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract.

(2) If a party does not have a place of business, reference is to be made to his habitual residence."

Article C ^{14/}

"This (Convention) (law) does not apply to contracts concerning goods, other property or services which are to be supplied for the personal, family or household purposes of a party, unless the other party, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the contract was concluded for such a purpose."

Article X (new article) ^{15/}

"The parties may by agreement only derogate from or vary the effect of articles D, E and F of this (Convention) (law)."

Article Y (new article) 16/

"Where, in accordance with the provisions of this (Convention) (law) the obligee is entitled to require performance of an obligation, a court is not bound to enter a judgment for specific performance unless the court would do so in respect of similar contracts not governed by this (Convention) (law)."

PART II: SUBSTANTIVE PROVISIONS

Article D

Previous draft

"Unless the parties have agreed otherwise, 17/ the obligee is not entitled to recover or to forfeit the agreed sum if the obligor is not liable for the failure of performance."

Revised draft

"If a failure of performance in respect of which the parties have agreed that the obligee is entitled to an agreed sum of money occurs, the obligee is entitled to the agreed sum unless the obligor [proves that he] 18/ is not liable 18a/ for the failure of performance."

Article E

Previous draft

"(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 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. " 19/

Revised draft 20/

"(1) Where the contract provides that the obligee is entitled to the agreed sum on delay in performance of an obligation, the obligee is entitled both to require performance of the obligation and to the agreed sum. 21/

(2) Where the contract provides that the obligee is entitled to the agreed sum on non-performance of an obligation, or defective performance other than delay, the obligee is entitled either to require performance, or to the agreed sum. If, however, [the obligee proves that] 22/ the agreed sum cannot reasonably be regarded as a substitute for performance, the obligee is entitled both to require performance of the obligation and to the agreed sum." 23/ 24/

Article F

Previous draft

"Unless the parties have agreed otherwise, 25/ 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 26/ 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."

Revised draft 27/

"Where the obligee is entitled to the agreed sum, he [is] not entitled to damages [/] [may] not assert a claim for damages [/] to the extent of the loss covered by the agreed sum. 27a/ He [is] also not entitled to damages [/] [may] also not assert a claim for damages [/] 26/ to the extent of the loss not covered by the agreed sum, unless he can prove that his loss grossly exceeds the agreed sum." 28/

Article G

Previous draft

- "(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." 29/

Revised draft 30/

- "(1) The agreed sum shall not be reduced by a court or arbitral tribunal.
- (2) Notwithstanding the provisions of paragraph (1) of this article, 31/ the agreed sum may ~~[shall]~~ be reduced ~~[though not below the extent of the loss suffered by the obligee]~~: 32/
- (a) if the agreed sum is shown to ~~[be]~~ grossly disproportionate in relation to ~~[grossly exceed]~~ 33/ the loss that has been suffered by the obligee; or
- (b) 34/ (i) if parties have provided that the obligee is entitled to the agreed sum even when the obligor is not liable for the failure of performance, and
- (ii) if the obligee claims the agreed sum when the obligor is not liable for the failure of performance, and
- (iii) if entitlement to the agreed sum would be manifestly unfair in the circumstances."

FOOT-NOTES

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

2/ A/CN.9/218.

3/ Report of the United Nations Commission on International Trade Law on the work of its fifteenth session (1982), Official Records of the General Assembly, Thirty-seventh Session, Supplement No. 17 (A/37/17), Chapter II, paragraph 17.

4/ Ibid., paragraphs 18-39.

5/ Ibid., paragraph 40.

6/ "in writing". While there was no consensus during the deliberations as to whether this requirement should be maintained, the prevailing view was that, if the form of a model law were adopted for the uniform rules, the issue of formal requirements for the agreement should be left to be determined by the State adopting the law. If the form of a Convention were adopted, the solution adopted in articles 11, 29 and 96 of the United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980) (hereinafter referred to as the "Sales Convention") should be adopted.

7/ "Forfeit". While there was general agreement that the rules should cover forfeiture as delimited in the commentary to the previous draft rules (A/CN.9/218, para. 20), concern was expressed that the translation of "forfeit" in the various language versions was unclear or inappropriate. In the revised draft rules, alternative solutions are provided. The first (suggested in the drafting group established at the fifteenth session of the Commission) is to substitute the phrase "is entitled to an agreed sum of money" for the phrase "is entitled to recover, or to forfeit an agreed sum of money". A commentary would then explain the scope of the phrase "is entitled to". The second is merely to substitute the word "withhold" for the word "forfeit", as the translation of "withhold" does not appear to pose the same difficulties.

8/ Exclusion of guarantees. There was general agreement that the rules should not apply when parties had provided that the sum agreed as liquidated damages or a penalty could be claimed under a guarantee (i.e. it is agreed between the parties that the obligor is to arrange for a guarantee to be opened by a financial institution in favour of the obligee, and that under this guarantee the obligee can claim from the financial institution the agreed sum if it falls due). To exclude such cases, the words "the other party (the obligee)" have been substituted for the words "another party (the obligee)", and the words "from the obligor" have been added.

9/ Types of agreements covered by the rules. It was noted that while the rules were only intended to cover agreements for liquidated damages and penalties, the wording of the previous draft rules might cover other types of agreements (e.g. parties had provided that an agreed sum was to be the payment for proper performance, but was to be withheld if performance was defective; parties had provided that an advance payment made by one party was recoverable by him if performance by the other party was defective; parties had provided that one party could make payment by instalments, but on default in the payment of any one instalment all outstanding instalments became immediately payable). In the revised draft rules, alternative solutions are provided. The first (suggested in the drafting group established at the fifteenth session of the Commission) is to add after the words "agreed sum of money from the obligor," the following words: "where such sum is intended as a pre-estimate of damages, or as a security for performance, or both". Because of the ambiguity of the word "security" in this solution, an alternative solution is to embody the same idea in more explicit terms by adding the following words: "where such sum is intended as a pre-estimate of damages to be paid by the obligor for loss suffered by the obligee as a consequence of that failure, or as a penalty for that failure, or both". The use of both the terms "pre-estimate of damages" and "penalty" in the latter wording would also clarify to those accustomed to common law concepts that the rules covered both liquidated damages and penalties as understood in the common law.

10/ If the uniform rules were to take the form of a Convention, it was suggested that the conditions under which the Convention would apply should be aligned with the conditions under which the Sales Convention applied. Accordingly, the article has been modified to bring about such alignment.

11/ New paragraph (1 bis) states explicitly the understanding implicit in the previous draft of the uniform rules. Its language is based on article 4(a) of the Sales Convention. It has been added in response to queries raised during the deliberations as to the extent to which the rules deal with the validity of the contract. As the opening phrase indicates, insofar as they provide that, subject to various articles of the rules, a penalty invalid under the common law is recoverable, the uniform rules expressly deal with the issue of validity.

12/ Secretariat supplementary provisions. Paragraph (2) is identical with the Convention on the Limitation Period in the International Sale of Goods (New York, 1974) (hereinafter referred to as the "Limitation Convention"), article 2(b), and the Sales Convention, article 1(2). Paragraph (3) is identical with the Limitation Convention, article 2(e), and the Sales Convention, article 1(3).

13/ Secretariat supplementary provision. It is identical with the Sales Convention, article 10, and in substance identical with the Limitation Convention, article 2(c) and (d).

14/ Secretariat supplementary provision. It is to some extent derived from the Limitation Convention, article 4(a), and the Sales Convention, article 2(a).

15/ There was general agreement on the substance of this new article. See foot-notes 17, 19, 25 and 30, below.

16/ See foot-note 20, below.

17/ Desirability of the power of modification. Although opinions were divided as to whether parties should be given such a power of modification, there was support for the view that such a power might be acceptable if under article G, in addition to the case envisaged at present, a court or arbitral tribunal were to be authorized to reduce the agreed sum where parties had modified the rule contained in this article, and recovery or withholding of the sum in such circumstances by the obligee would be manifestly unfair. (See revised article G, subparagraph 2(b) and foot-note 34, below.) As to the drafting, there was general agreement that the power of the parties to modify the rule contained in the article should be deleted and set forth in a separate article. This separate article should also set forth the power to modify the rules contained in articles E and F. Accordingly, article X above has been added to the rules.

18/ Burden of proof. Under one view expressed during the deliberations, the article should indicate that the obligor bears the burden of proving that he is not liable for the failure of performance if he wishes to defeat the obligee's claim to the agreed sum. Under another view, the issue of the burden of proof should be left to be determined by the applicable law. If the former view is adopted, the words "/proves that he"/ may be added. It may be noted that article 79(1) of the Sales Convention expressly indicates who bears the burden of proof when a party relies on an exemption:

Art. 79(1): "A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control" (emphasis added).

18a/ Whether the obligor is not liable would be determined by reference to the terms of the contract and the law which, under the rules of private international law, would be applicable to determine the rights and obligations of the parties. The obligor would not be liable if he has a sufficient defence for his failure of performance (e.g. an exemption clause is applicable).

19/ The power of the parties to modify the rules contained in this article is now set forth in a separate article (article X above), and accordingly this paragraph is deleted.

20/ Entitlement to require performance, paragraphs (1) and (2). There was wide agreement that an article such as the present defining the relationship between the obligee's right to require performance of an obligation and his right to the agreed sum was desirable. However, it was noted that the various legal systems had different approaches to enforced performance, and there was general agreement that the uniform rules should not interfere with the conditions under which and the methods by which legal

systems made orders for enforced performance. If an obligee chose to require performance, the extent of his remedies should be determined by the court. Accordingly, Article Y above, which is based on article 28 of the Sales Convention, has been added under which a court is not bound to enter a judgment for specific performance unless the court would do so in respect of similar contracts not governed by the Convention or law. The phrase "entitled to performance" has been changed to "entitled to require performance" to accord with the terminology of the Sales Convention.

21/ Substance of paragraph (1). Subject to the qualification noted above as to the enforceability of performance, there was wide acceptance of the substance of paragraph (1).

22/ Burden of proof. To accommodate the suggestion that the paragraph should clarify who bears the burden of proving that the agreed sum cannot reasonably be regarded as a substitute for performance, the addition of the words "[the obligee proves that]" is suggested.

23/ Drafting of paragraph (2). There was general agreement that the circumstances when an obligee could only obtain either the performance or the agreed sum, and the circumstances when he could obtain both, should be set forth in separate sentences.

24/ Substance of paragraph (2). The majority view regarded the substance of paragraph (2) as an acceptable compromise. A minority view noted that it was sufficient for the paragraph to provide an alternative choice between requiring performance or recovering or withholding the agreed sum; the cumulation of remedies provided in the second sentence might in some circumstances unjustly enrich the obligee.

25/ The power of the parties to modify the rules contained in this article is now set forth in a separate article (article X above). Accordingly this opening phrase is deleted.

26/ Possible clarification as to the right to damages: The discussion appeared to reveal the need for a possible clarification of the phrase "is entitled to damages" contained in the previous draft. It was suggested that these words might be interpreted as giving a right to damages under the article itself in the circumstances indicated therein (i.e. when the obligee can prove that his loss grossly exceeds the agreed sum), without the need to prove liability under the applicable law. The possibility of this interpretation might be reduced by the use of a phrase similar to the alternative phrase ["may not assert a claim for damages"] suggested in the revised draft.

27/ The article has been modified to accord with the view widely expressed during the deliberations that it was unnecessary in this article to set forth the right of the obligee to recover the agreed sum, and that the article should only define the circumstances in which the obligee would be entitled to damages in addition to the agreed sum.

27a/ It has been noted that, while it was clearly understood during the deliberations that the obligee was not entitled to damages to the extent of the loss covered by the agreed sum, the previous draft only dealt with the obligee's entitlement to damages to the extent of the loss not covered by the agreed sum. The article has been modified to make explicit the understanding reached during the deliberations.

28/ There was considerable support for the view that the previous draft tended to obscure the fact that very often the agreed sum was intended by the parties to be a ceiling on liability, and instead tended to focus on the circumstances in which the ceiling could be avoided. Drafting changes have been made to secure a better balance, without changing the substance of the article.

29/ The prevailing view was that the article should not require as a condition for reduction that the agreed sum could not reasonably be regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee.

30/ Mandatory character of article G. There was general agreement that parties should have no power to modify article G, and that this fact should be made explicit (see article X, above).

31/ It was suggested that the fact that paragraph (2) qualified paragraph (1) should be made clearer. Accordingly, the word "However" in the previous draft has been replaced by the phrase "Notwithstanding the provisions of paragraph (1) of this article". The latter phrase follows article 44 of the Sales Convention.

32/ Discretion as to reduction. It was noted that the article left two issues to the discretion of the court or tribunal: whether to reduce the agreed sum, even if the conditions for reduction were satisfied, and the extent to which the agreed sum was to be reduced if it were decided to make a reduction. Under one view this created an undesirable measure of uncertainty as to the operation of the article. The words "[shall]" and "[though not below the extent of the loss suffered by the obligee]" contain proposals directed to these issues.

33/ Under article F, in order to recover damages in excess of the agreed sum, the obligee must prove that his loss "grossly exceeds" the agreed sum. The use of the same phrase is proposed in the present article, instead of the phrase "grossly disproportionate in relation to" used in the previous draft. The latter phrase appears to have the same meaning as the former in the context of the present article.

34/ Relation between article D and new subparagraph 2(b). Sub-paragraph 2(b) has been added for the reasons set forth in foot-note 17 above to article D. The widening of the power of reduction under the present article was proposed only as a remedy to cases of hardship which might occur if parties were permitted to modify Rule D, i.e. where the parties had provided that the obligee would be entitled to the agreed sum even if the obligor was not liable for the failure of performance, and the obligee did in fact make a claim when the obligor was not liable. If the agreed sum so claimed grossly exceeded the loss suffered by the obligee, the obligor could claim a reduction under subparagraph 2(a) of this article. It was proposed during the deliberations, however, that even if the agreed sum did not grossly exceed the loss suffered by the obligee, the obligor should be entitled to some relief, and that a court or arbitral tribunal should be given the power to reduce the agreed sum if enforcing payment of the sum would be manifestly unfair to the obligor. Article 4(1) of the common provisions set forth in the annex to the Benelux Convention relating to the Penalty Clause, adopted at the Hague on 26 November 1973 provides: "A la demande du débiteur, le juge peut, si l'équité l'exige manifestement, modérer les effets de la clause pénale,"