Damages, Exemption Clauses, and Penalties

The last draft of the Unidroit project comprises twelve articles on damages (there were more in the initial draft) and two articles on exemption clauses and "agreed payment for nonperformance", in other words penalty clauses.

These fourteen articles are the result of fierce discussions prompted by conflicting traditions governing the respective domestic laws of remedies. Of course, the U.N. Convention on Contracts for the International Sale of Goods (CISG) served as a starting point. But it is not comprehensive and lacks, for instance, specific rules on exemption and penalty clauses. In other cases the CISG rules are ill-adapted; their scope being limited to sales of goods, they cannot be easily extended to other kinds of contracts such as to contracts for services. In addition, certain rules are defective: CISG is not a perfect model. Some "trompe-l'œil" formulas just mask deep and lasting oppositions. The Unidroit group has tried to improve it, both in substance and in form.

The group sought Inspiration, for the civil law tradition, in the major codifications of the Romano-Germanic system beginning with the ancestor, the French Civil Code of 1804, the middle-aged codifications of Germany, Switzerland and Italy, and the new-born (or about to be born) Quebec Civil Code and Dutch Civil Code (NBW).¹

Article Two of the Uniform Commercial Code and the Restatement (Second) of Contracts² were main sources for the common law tradition. The influence of socialist countries has declined, even if the Republic of China still represents this family of laws in the group. The interests of developing countries are always a concern since they are often in the situation of consumers in international trade and are to be protected as such. And it must noted that there was, as elsewhere, a close cooperation with the Commission for European contract law.³

The group has always tried to reach solutions which were agreeable to all systems, provided that this solution was the best suited to "international commercial contracts." Of course, as in every work of compromise, these solutions may be criticized from a wide range of perspectives. Some rules will seem superfluous, but things which are obvious in certain systems are not in others. A few rules may seem ill-advised to some because they are very different from their own law but are in fact vital to other systems. In the same vein, a permanent effort to adapt the rules so that they could be easily formulated both in English and in French-the two working languages of UNIDROIT-was made.

Regardless of the outcome, the preparation of these provisions has been a constructive exercise in comparative law, even if, sometimes, the participants found it difficult to relinquish their traditional approach.
Perhaps the most fundamental issue arose from the preparation of chapter 7 on non-performance: were damages to be the main remedy or could performance \textit{in natura} be placed on the same level? The Holmes formula was set aside, and the old canon law principle \textquote{Pacta sunt servanda} was favored on the ground that a contract bears more than a purely economic aspect.\(^4\) In the Unidroit system, there is no privileged remedy. The aggrieved party may freely opt for specific performance, termination and/or damages, no hierarchy being imposed between them.

This principal question being settled, it is now possible to review the general rules (articles 7.4.1 to 7.4.12) and then the clauses which may provide exceptions to these rules (articles 7.4.13 and 7.4.14).

\section{I. THE GENERAL RULES ON DAMAGES}

Twelve articles deal with general rules: nearly the same number of provisions as in the Second Contracts Restatement, the French civil code and the new Quebec Civil Code. This is much more than the CISG which comprises only four articles (which are however longer).

It would be tedious to review all 12 provisions because some are of a technical character. Instead, I have chosen the rules which raised major difficulties: first, the general approach (art. 7.4.1, 7.4.2 and 7.4.3) and then, controversial issues: foreseeability and mitigation.

\subsection*{A) The General Approach to Damages}

There are three major rules in the first three articles: the right to damages (7-4-1) the principle of full compensation (7-4-2) and the certainty of harm (7-4-3).

According to article 7-4-1, the right to damages is general: the aggrieved party may always ask for damages unless the non-performance is excused by law (in case of impossibility) or by agreement (in case of an exemption clause). The nature of the non-performance is irrelevant: the aggrieved party must only prove non-performance, whether it is an obligation to achieve a certain result \textit{(obligation de résultat)} or an obligation of best effort \textit{(obligation de moyens)}. It is not necessary to prove fault in addition to the non-performance of the contractual obligation. Damages are due for all kinds of non-performance: total lack of performance, late performance or defective performance. Damages may be awarded as an exclusive remedy or combined with others such as specific performance or termination.

Article 7-4-2 (1) enunciates the \"full compensation\" principle according to which damages must be measured by the harm, incurred, neither more nor less. Important consequences flow from this principle.

The first consequence is that the court has no power to mitigate the damages for reasons of equity-a power which exists in the Swiss Code of Obligations (article 44-II) and in the NBW (6-109). The second consequence is the causality principle, in that the harm must be the result of the non-performance. This is one way to envisage the question of remoteness, the other being the foreseeability of the harm, discussed below. From the full compensation principle derives also the rejection of punitive damages (almost superior to the actual harm incurred).\(^5\)

Article 7-4-2 states the general rule on the assessment of damages which is in conformity with article 74 of the CISG and with the old Roman law tradition: the harm consists of the loss suffered \textit{(damnum emergens)} and the gain lost \textit{(lucrum cessans)}. This approach differs from the \"expectation/reliance\" rule-since expectation interest and reliance interest do not coincide with \textit{damnum emergens} and \textit{lucrum cessans}.\(^6\) \textit{Lucrum cessans} is necessarily an expectation loss but \textit{damnum emergens} may either be an expectation or a reliance. The traditional Roman law solution appeared to be clearer and simpler. The end result ought to be similar in most cases as the text specifies that the Court must take "into account any gain to the aggrieved party resulting from his avoidance of cost or harm."

Notwithstanding the fact that the rule on \"certainty of harm\" (article 7-4-3) can be found in Section 352 of the Second Contract Restatement, it is not a traditional common law rule; however, it is very familiar to civil lawyers.\(^7\) The harm to be compensated must not be hypothetical or speculative. It must be established with a reasonable degree of certainty, as to
its existence and its amount.

This rule solves the problem of the future losses: they must be compensated whenever it is certain they will occur, even if their amount is not yet ascertained. It also answers the problem-often discussed in French legal literature-of the loss of a chance (for instance, the loss of a chance of recovery for a patient).

The assessment of damages is in all cases at the discretion of the judge, who cannot refuse to evaluate on the ground of the difficulties the process involves: he must allocate damages even if it is not easy to do so. Nominal damages, consequently, cannot be awarded. Certain difficult points, within this framework triggered heated, and sometimes intricate, discussions.

B) Some Disputed Points

I have chosen two issues which enhance the difficulties to conciliate the opposing view points of common law and (so-called) "civil law": foreseeability and mitigation of harm.

Foreseeability of harm is an interesting topic from a comparative point of view. Certain systems do not possess such a rule because foreseeability is merged with the notion of causality: it is the case of German, Swiss or Dutch law (art. 6-98 NBW). Other systems refer to foreseeability but have a different approach to it, despite superficial similarities. At common law, foreseeability is more or less a question of causality, and Section 2-715(2)(a) of the UCC speaks of "consequential damages." Moreover, according to the rules in Hadley v. Baxendale, foreseeability is a test for remoteness: what was not foreseeable at the time of the contract is a loss too remote to be compensated. And this is why foreseeability is also used in tortious liability.

In the civil law countries where foreseeability is one of the criteria, such as in article 1150 of the French Civil Code and article 1125 of the Italian Civil Code, art. 1225 C.Civ. italien, the rule is more refined: foreseeability is a limit to compensation for direct harm; it is an exception to the full compensation principle in favor of the performing party when the latter acted in good faith. The limit does not apply in case of deliberate or grossly negligent non-performance. This stems from the more acute "moralist approach" of the civil law. But there is also an economic justification: a party may estimate in advance the amount of damages to be paid (or for which insurance must be brought). The rule is, by necessity, specific to breaches of contract.

After many discussions and numerous versions, it was decided to follow more or less the CISG rule-the idea to treat differently the non-performing party according to its good or bad faith was rejected. But there is no certainty that article 7-4-4 will be construed identically by a French or an English court. A French judge may consider that it is contrary to public policy to allow a party having committed a deliberate breach to resort to foreseeability in order to limit his ability.

The rule concerning mitigation is of great importance and has so many consequences at common law, that common lawyers are very much surprised to learn that this rule is ignored in many other systems, where some of the consequences of the mitigation principle are not accepted or are dealt with under other rules. Such is the case with French law where the innocent party is under no duty to mitigate and has nothing to do but exercise his remedies. For instance, there is no duty to make a covering transaction, unless a usage to do so commands it or that inaction would be abusive.

Mitigation has gained recognition in CISG and in the new codes (article 77, CISG-in a rather cumbersome way, more elegantly in art. 1475 of the new Civil Code of Quebec and indirectly in article 9.96, 2,a) of the NBW). The rule was retained by Unidroit in article 7.4.8. But, in this case as well, it is a concern that the rule will be applied differently according to the legal background of the judge; for instance in the assessment of the "reasonable steps" the aggrieved party has to take. To reach complete uniformity will require a long period of time.
II. AGREEMENTS ON DAMAGES: EXEMPTION CLAUSES AND PENALTY CLAUSES

The basic idea is the same everywhere: on the one hand, such clauses are valid under the principle of autonomy of will; on the other hand, there must be some kind of control because such clauses may infringe public policy (penalty clauses at Common law) or become abusive or unfair or unconscionable.

Of course, rules on consumer protection exist almost everywhere, whatever technique they may resort to (nullity, avoidability, judicial control, etc.). As such, they do not concern the Unidroit rules, which neither govern customer contracts nor interfere with mandatory legislation.

From the start, we were confronted with the question of introducing a general rule giving the judge the power to eliminate an abusive term, on the model of Section 2-302 of the UCC (unconscionability) or NWB 6-2 and 6-248-2, or the very recent French caselaw.

There is no such direct rule in the Unidroit Principles. The nearest is the general duty of good faith and fair dealing of article 1-8 and the rule of article 3-9 on “gross disparity,” which invalidates clauses conferring an “excessive advantage.” But this is closer to the "lesion" concept than it is to unconscionability.

The working group agreed on the need to have some kind of judicial control of these clauses but it was difficult to reach an agreement on how to draft it. The national traditions are very diverse. For instance, the common law countries are less hostile to exemption clauses that most civil law countries; but the opposite is true for penalty clauses. Here again, a compromise had to be found in order to achieve a result tolerable to all.

A) Exemption Clauses

A comparative survey shows that judicial control of such clauses is more or less strict, as it is in England (outside the Unfair Contract Terms Act, 1977) when compared to Germany or France. Two techniques may be used.

One is to be found in the French caselaw, in the Italian Civil Code (article 1229), in the Swiss Obligation Law (article 100-I), or in the Quebec Civil Code (article 1470): the enforceability of the clause depends on the behavior of the defaulting party. If the non-performance is deliberate or grossly negligent (according to the famous Roman law maxim: culpa lata dolo aequiparatur), the exemption clause is unenforceable: we find again the civil law moralist approach.

The other solution is to consider the reasonableness (or conformity to good faith) of the clause, in its commercial context, whether as a general rule (UCC or Section 242 of the BGB) or as a rule an exemption clauses specifically (Unfair Contract Terms Act, 1977).

The working group hesitated on the ground to use. The first draft joined two tests, gross unfairness and deliberate breach. Then the second branch of the test was eliminated. But the formula "grossly unfair, having regard to the purpose of the contract" is sufficiently vague to leave much to the discretion of the court. A French judge, for instance, will tend to consider grossly unfair to exclude liability the case of a deliberate breach; he may even consider as against public policy the intent to disfigure oneself from the consequences of voluntary non-performance.

B) Penalties and Liquidated Damages

Public policy is also involved in these clauses. An agreed payment "in terrorem" is void in certain systems (common law and Belgium, for instance) whereas it is considered valid in others, and even commendable as an incentive for performance "in natura."

Hence the many discussions, which ended with the present text, which is similar to those found in many western European systems. It recognizes the validity of all liquidated damages "irrespective of the actual harm," even if the fixed sum is deliberately higher than the expected harm. But there is a limit (which has been set by many legislations): the penalty may not be "grossly excessive with respect to the actual harm." In such a case, the judge has the power to reduce the amount of the penalty.
Of course, this "pouvoir modérateur" may be used differently, according to "the length of the Lord Chancelor's foot." It is unavoidable whenever a discretionary power is granted to judges. In these cases, the existence of judiciary discretion was necessary for common lawyers to overcome their innate distrust of penalty clauses.

To achieve a more or less satisfactory result involved hard work, great effort at mutual understanding and a certain amount of grief. It is sometimes difficult for the rapporteurs of a chapter to see parts of their cherished drafts torn to pieces by the group. And then, harmonization is not a process which ends with a simple proposal. This proposal must be submitted to the approval of the scholarly community, adopted by practitioners and applied by the courts or arbitrators. One of the greatest law-reformers, Portalis, wrote in 1804 "les codes des peuples se font avec le temps; mais, à proprement parler, on ne les fait pas." For the Unidroit principles, also, time will tell.

See A. Hartkamp, supra. The English and French translation of the Patrimonial part of the NBW has been most useful.

It must be remembered that E. Allen Farsnworth is a member of the group-and an influential one.

See O. Lando, supra.

On these two aspects, see D. Harris & D. Tallon, Contract Laws Today, Anglo-French Comparisons 385-86 (1989).

Compare article 74 of the CISG.

There is a contradiction in the common law which recognizes punitive damages but rejects penalties.


The question of non-performance due in part to the aggrieved party could also have been retained, as a question which is not always very well understood in contractual matters. The reason is that it is often overshadowed by "faute de la victime" or contributory negligence in tortious liability. And the notion of mora creditor is not used everywhere. See art. 80 CISG (which has been diversely interpreted) and Unidroit 7-4-7.

D. Harris supra n. 4, at 275-78, 292-93.

"Consequential" damages, as well as "incidental" damages are very difficult expression to translate into French since the expression "préjudice indirect" bears a quite different meaning.

9 Ex. 341 (1854).

Compare article 74 of the CISG.


Referring Principles:

VI.4 - Promise to pay in case of non-performance

VII.2 - Principle of foreseeability of loss

VII.4 - Duty to mitigate