



**T. C.**  
**BURSA**  
**ULUDAĞ UNIVERSITY**  
**INSTITUTE OF SOCIAL SCIENCES**  
**DEPARTMENT OF PRIVATE LAW**

**COMPARATIVE ANALYSIS OF CONSEQUENCES  
OF BREACH OF CONTRACTS AND THE  
IMPLEMENTATION IN STANDARD  
CONSTRUCTION CONTRACTS**

**MASTERS DEGREE THESIS**

**Gago Mealii RIGGA**

**BURSA - 2019**





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**Supervisor:**

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### **COMPARATIVE ANALYSIS OF CONSEQUENCES OF BREACH OF CONTRACTS AND THE IMPLEMENTATION IN INTERNATIONAL STANDARD CONSTRUCTION CONTRACTS**

**This study focuses on elaborating on the various sanctions that arise in the event one party of a contract fails to perform their part of obligation. Each of the widely recognized sanctions are analyzed and examined from the position or perspective of major legal families.**

**Common law and Civil law are the main legal traditions. However, they are quite distinct and different. While their common goal is creating a fair and just legal system which provides certainty and protection to all legal families, each of these two systems has its own unique manner in how they deal with legal issues. The events of their respective histories have led towards certain fundamental similarities and differences. As such, this study looks at how similar contractual sanctions have been**

dealt with under Civil law, Common law, as well as the approach of international sources of law towards the same sanction.

In the same connection, there is an increase of globalization in the world economy and people across various legal jurisdictions are entering into contracts. In light of that, this study pays a particular attention to standard construction contracts. FIDIC contracts, are reputed as the leading contracts in international engineering and construction projects, as such, in the third chapter of this study, we shall conclude by looking at how the law governing standard international contracts, i.e. FIDIC Contracts, deal with the various sanctions.

The reason for looking at these construction contracts is because they operate in an international environment, characterized by conflict of jurisdictions, and as such the study aims to show what the law governing international standard construction contracts stipulates, this is more so in order to determine how these laws have been able to adopt or rather assimilate the various influences from the diverse legal backgrounds and how they create a balance between people from different legal backgrounds that enter into such contracts.

**Key Words:** Contractual Remedies; Specific Performance; Damages; Termination; Liquidated Damages; Penalty; Withholding; Price Reduction; International Contract; Comparative Study; Standard Construction Contracts



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### KARŞILAŞTIRMALI HUKUKTA ULUSLARARASI İNŞAAT SÖZLEŞMELERİNİN İHLALİNİN SONUÇLARI

Bu çalışma, sözleşmedeki taraflardan birinin yükümlülüklerini yerine getirmemesi durumunda ortaya çıkan çeşitli yaptırımlara ele almaktadır. Karşılaştırmalı hukukta kabul edilen yaptırımlar, hakim ana iki hukuk sisteminin temel prensiplerine göre şekillenmektedir.

Anglo Sakson ve Kıta Avrupası Hukuk Sistemi, dünyada hakim başlıca yasal sistemlerdir. Ancak, birbirlerinden oldukça farklıdırlar. Ortak hedefleri, adil yasal sistem oluşturmak olsa da, bu iki sistemin her biri, hukuki sorunların çözümü konusunda kendine has bir özelliğe sahiptir. İlgili hukuk sistemleri bazı temel benzerliklere ve farklılıklara sahiptir. Bu nedenle, bu çalışma uluslararası hukuk kaynaklarının aynı ihtilafa yönelik yaptırımların karşılaştırmalı hukukta nasıl ele alındığını incelemektedir.

Küreselleşmenin etkisiyle farklı hukuk düzenlerindeki insanlar sözleşme ilişkisine girmektedirler. Bu çerçevede, bu çalışma standart inşaat sözleşmelerini

zellikle ele almaktadır. FIDIC szlemeleri, uluslararası mhendislik ve inaat projelerinde uygulanması kabul gren szlemeler olarak kabul edilmektedir. Bu sebeple alımanın nc blmnde, standart uluslararası szlemelerde kullanılan FIDIC Szlemelerinde yer alan eitli yaptırımlar ele alınacaktır.

alımanın amacı, yargı ihtilafları ile karakterize edilen uluslararası alanda faaliyet gsteren inaat szlemelerinin dayandıđı yasal dzenlemeleri gstermektir. Bu yasalar, teamllere dayanmakta ve bu tr szleme ilikisine giren devletler arasında uyum, benzer uygulama sađlamaktadır.

**Anahtar Kelimeler:** Szlemenin ihlali ; Aynen ifa; Tazminat; Szlemenin Feshi; Bedel İndirimi; Uluslararası Szleme; Karılatırma alıması; Standart İnaat Szlemeleri.

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## ABBREVIATIONS

Art.	:Article
BGB	:German Civil Code
CISG	:United Nations Convention on Contracts for International Sale of Goods (1980).
D.A	:Date of Access
DCFR	:Draft Common Frame of Reference (2003)
Ed.	:Edition
English SGA	:English Sale of Goods Act (1979)
Et. al.	:and others
FCC	:French Civil Code
FIDIC	:Conditions of Contract for EPC/Turnkey Projects (“Silver Book”), issued by the International Federation of Consulting Engineers (1999).
GTC	:General Terms and Conditions
Hacettepe HFD	:Hacettepe Hukuk Fakültesi Dergisi
Ibid	:Mentioned in a Previous Reference
Iss.	:Issue
LD	:Liquidated Damages
M&E	:Mechanical and Electrical
MÜHF – HAD	:Marmara Üniversitesi Hukuk Fakültesi Hukuk Araştırmaları Dergisi
No.	:Number
ORGALIME	:Turnkey Contract for Industrial Works, issued by the European Engineering Industries Association (2003)
p.	:Page

pp.	:Pages
Pace Int'l L. Rev.	:Pace International Law Review
Para	:Paragraph
PECL	:The Principles of European Contract Law (2002)
Prof.	:Professor
Sec.	:Section
Subpara	:Subparagraph
TCO	:Turkish Code of Obligations
TCCP	: Turkish Code on Consumer Protection
UCC	:Uniform Commercial Code of the USA
UK	:United Kingdom of Great Britain and Ireland
UNCITRAL	:United Nations Commission on International Trade Law
US	:United States of America
UCLA	: University of California, Los Angeles.
Uwa Law Review	:The University of Western Australia Law Review
Vol.	:Volume
vs.	:Versus
WAN	: Wide Area Network
w.date	: Without a Publication Date
www	: Worldwideweb

## **INTRODUCTION**

As earlier stated, this study investigates the various contractual sanctions applied in different legal jurisdictions. The study will examine the uniqueness and differences in application of similar remedies across the two major legal traditions i.e. Common Law and Civil Law, as well as in International sources. The nature of contractual sanctions, their role, as well as specifics of applications will be highlighted. Moreover, the study shall examine these sanctions from their point of convergence and utilization in the sphere of international contracting by using the example of standard construction contracts which are commonly adopted in international contracts.

Generally speaking, a contract is a voluntary agreement between parties (two or more), loosely speaking it is also called a promise, but one with the aim of establishing legal obligations (rights and responsibilities). For a contract to be valid, all parties must have been agreeing to the same thing, and not talking at cross-purposes.

Contracts can be entered into in either written or oral form. Every legal jurisdiction has their own laid down requirements to the formation and execution of a contract. The law relating to contracts largely varies from jurisdiction to jurisdiction due to the different historical development, local traditions and micro-economies. Nonetheless, there exists several elements and/traits that are commonly shared and accepted as vital, for instance, as to what constitutes a contract.

The main elements of a contract commonly agreed by all the different jurisdictions are, offer, acceptance, and consideration. It is also agreed that whenever the promises set forth in a contract fail to be performed, i.e. breaches of contractual obligations, then consequences, which can also be referred to as sanctions, must follow.

In response to a contractual breach, each state has developed its own structure of sanctions and enforcement procedure. However, in the wake of globalization and increased cross boarder commercial activities, the existence of each state having its own different system has created boundaries or in other words limits because of the confusion that is



likely to arise where the parties to a contract come from diverse legal backgrounds. Legal theory therefore has to adjust to the present social and economic realm in order to produce satisfactory results in serving the overall progress of a global world.

The United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980) defines international commercial contracts as one where the parties concluding the agreement come from two or more different jurisdictions. More flexible definitions of 'international contracts' are possible, such as, contracts that have significant connections with more than one state, or those that involve a choice between the laws of different countries.

Because of the interplay of laws from different contracts, international contracts, as well as the sanctions that arise from such contracts, present an outstanding example of foundation created by virtue of legal transplanted, incorporating influences from various legal orders, academic doctrines, and diverse court precedents.

At the same time, it is important to note that the sanctions under international contracts are also significantly affected by tensions and contradictions persisting between the different legal systems. As such, the whole purpose of sanctions, which is to serve as a protection of the contracting parties, may be hindered, especially if the agreement incorporates a system of remedies which may not be fully enforced under the governing law of a particular country.

As such, it becomes important to discuss the various contractual sanctions as applied in the various legal orders, highlight the differences and points of convergence, in an effort to bring further harmonization of remedial regimes across jurisdictions and create a possible option of productive utilization in international contracts.

## CHAPTER ONE

### GENERAL OVERVIEW OF CONTRACTUAL SANCTIONS

The first part concerns a general overview of what follows in the event a party to a contract fails to meet its obligations. It will focus on introducing and explaining the whole concept of sanctions, being a primary consequence of non-performance in contracts under the law.

#### I. DEFINITION OF CONTRACTUAL SANCTIONS

The term sanction can be defined as a strong action taken in order to make people obey a law or rule, or a punishment given when they do not obey<sup>1</sup>. The concept of sanctions, generally aims to act as a means of correcting a wrong.

In a legal context, sanctions is the means by which a right is enforced or the violation of a right is prevented, redressed (made right or repaired) or compensated<sup>2</sup>. In essence, a sanction cures the violation of a legal right and is the means to achieve justice in any matter in which legal rights are involved.

Legal sanctions can be ordered by the court or any other judicial body, and they may take several forms. For instance, they may be granted by a final judgment given at the end of a trial/hearing, or they could take the form of provisional remedies, which simply act as a temporary solution to hold matters in status quo pending a final decision. Sanctions may also come about by agreement (settlement) between the person claiming harm and the person he/she believes has caused it, as well as arise by the automatic operation of law.

Furthermore, by its definition, it is evident that for any sanction to arise, there must be a breach. In the context of contract law, a breach means a failure, without legal justification, to perform an obligation under the contract as required by the terms of the

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<sup>1</sup> Cambridge Dictionary, D.A 27. 6.2018, <https://dictionary.cambridge.org/dictionary/english/sanction>.

<sup>2</sup> Henry Campbell BLACK, *Black's Law Dictionary*, 6<sup>th</sup> Ed., West Publishing Company, 1990, p. 1294.

agreement<sup>3</sup>. Contractual sanctions are therefore consequences of such breach and arise to correct such breaches. In short, in the event a party has suffered a breach of contract, regardless of whether the defaulting party intended it or not, the right to have sanctions imposed, arises.

They are several sanctions, or in other words reliefs, which may be prescribed in the event of breach, and they all inherently differ from each other, in terms of their characteristics as well as specific aims. One well known example of a sanction for breach of contract is compensation in monetary form, known as damages, and while it may have other specific aims and functions, the general intended aim of damages, as well as other sanctions, is to put right the defect that has arisen as a result of a breach<sup>4</sup>.

In essence, the law of contractual sanctions is concerned with the character and extent of relief to which an individual who has brought a legal action is entitled. This is of course only once the appropriate laid down procedure has been followed, and the individual has established that he or she has a substantive right that has been infringed by the defendant, that the law of contractual sanctions comes into play.

The discussions above bring to light what is believed to be the three basic characteristics of every contractual sanction: (i) a sanction, which may also be known as a remedy, is an entitlement, i.e. a legal right, (ii) a sanction is created following the violation (including the anticipated violation) of a pre-existing right. It is therefore a consequence that comes about due to this violation, as well as a secondary right, (iii) from the standpoint of an aggrieved party, a sanction involves a practical benefit or advantage, awarded him for the sake of alleviating the grievance or harm cause by the breach of terms.

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<sup>3</sup> David M. WALKER, *Law of Contracts and Related Obligations in Scotland*, 3<sup>rd</sup> Ed., p. 519.

<sup>4</sup> Mary CHARMAN, *Contract Law*, 4<sup>th</sup> Ed., Willan Publishing, p. 210.

## II. NATURE AND FUNCTIONS OF CONTRACTUAL SANCTIONS

### A. Nature of Contractual Sanctions

Contractual sanctions are by their nature a system of default rules<sup>5</sup>. As earlier stated, after a contract is signed, it may occur that one of the parties fails to perform his agreed obligations and consequently becomes in default, in such instances, contractual sanctions, make explicit what is to happen<sup>6</sup>. These default rules, which are usually in place in each country, apply in the absence of explicit contract terms to the contrary.

All legal regimes in the different jurisdictions stipulate contractual sanctions for wrongs that arise in a contract<sup>7</sup>. Some scholars tend to classify these sanctions into two forms, i.e. as equitable or legal in nature.

Legal sanctions/reliefs take a monetary form mostly and are awarded to a plaintiff to adequately compensate him or her for the loss or injury. The aim of the court in awarding these forms of reliefs is to restore the victim to the position he held before the breach. The most common example of Legal sanctions is damages. The usual goal of damages is to put the claimant in the position that it would have been in had the contract been performed; that is, to give the claimant the “benefit of the bargain”<sup>8</sup>. This sort of sanction is largely used in common law jurisdictions/ Anglo American system.

However, some people feel that legal remedies are flawed and imperfect and do not protect or promote the concept of a contract. It has been argued that, if the foundational premise of the conception of the contract is that it represents the very will of the parties, and if we believe that contract law seeks to have enforced, to the extent possible, the parties’ subjective wills or rather wishes, then it follows that this theoretical premise

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<sup>5</sup> Graham VIRGO, *Commercial Remedies: Resolving Controversies*, Cambridge University Press, 2017, p. 46.

<sup>6</sup> Randolph SLOOF, Hessel Oosterbeek and Joep Sonnemans, *On the Importance of Default Breach Remedies*, Paper was presented at the Experimental Law and Economics conference in Bad Meinberg (June 2006).

<sup>7</sup> Samuel L. BRAY, “System of Equitable Remedies”, *UCLA Law review*, Vol. 63, 2016, pp 530-592, p. 551.

<sup>8</sup> David PEARCE and Roger HALSON, “Damages for Breach of Contract: Compensation, Restitution and Vindication”, *Oxford Journal of Legal Studies*, Vol. 28, Iss. 1, 2008, pp. 73-98, p.80.

dictates that the contractual obligation actually be performed<sup>9</sup>. This school of thought is followed by many civil law countries and it is on the basis of such arguments that equitable sanctions have arisen.

An equitable sanction is one in which a recovery of money is viewed as an inadequate form of relief. By and large, equitable sanctions are related to fairness, as opposed to the actual monetary damages suffered as the result of a breach. Equitable sanctions are mostly given in instances where it is shown that legal sanctions are inadequate, and do not sufficiently help the injured party in a contract.

One of the major forms of equitable sanction is specific performance, which will be discussed in depth in ensuing chapters. Other significant equitable remedies are injunction, and equitable restitution<sup>10</sup>.

Further, and as can be inferred from above, there is no unity and clarity in the contemporary legal science between the different views on the nature of the contractual sanctions. Take for example, while in common law countries, courts are quick to issue legal sanctions, in contrast to common law countries, specific performance which is an equitable sanction, is at least in theory a preferred remedy in civil law systems<sup>11</sup>. It has been argued that this is because the very definition of sanctions is approached differently by the two major legal systems. In the Anglo-American system, a sanction is principally defined as a legal response (action) to a “civil wrong” and the law of sanctions is intended to determine the exact suitable remedy against respective group of civil wrongs. On the other hand, in the civil law system, a sanction is primarily understood as part of the obligation,

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<sup>9</sup> Rosalie JUKIER, *Taking Specific Performance Seriously: Trumping Damages as the Presumptive Remedy for Breach of Contract*, This paper was presented at the Canadian Institute for the Administration of Justice (CIAJ) Conference entitled “Taking Remedies Seriously” in Ottawa, Ontario, 2009, pp. 87-117, p. 90.

<sup>10</sup> Doug RENDLEMAN, “Remedies: A Guide For The Perplexed”, 2013, *Saint Louis University Law Journal*, Vol. 57, pp. 567-584, p. 570.

<sup>11</sup> Eugen BUCHER, *Law of Contracts -Introduction to Swiss Law 103*, 2<sup>nd</sup> Ed., 1995, p.112.

“entitlement [right] arising out of the breach of an obligation (or duty) and taking the form of a burden [alternative duty] imposed on the person responsible for that breach”<sup>12</sup>.

In other words, these two legal traditions have distinctive concepts of contract liability: in common law, sanction is just an alternative of the same obligation, while in civil law system, sanction is the effect from non-performance of obligation or sanction<sup>13</sup>.

The difference between these two legal traditions, with regard to their perception of what character a contractual sanction takes, probably stems from mixing different contractual doctrines and their sources<sup>14</sup>.

It is often said that under common law, contracts and the system of sanctions that arise as a result of breaches in contracts, was highly promoted by economical contemplations and practical demands, and this explains why common law system treats damages which mostly comes in form of monetary compensation to the aggrieved party, as one of the significant sanctions in the event a default occurs.

On the other hand, under civil law, contracts (including the system of sanctions that arise as a result of breaches in contracts) has always been deeply rooted in academic science elaborating on moral aspects of law, and hence when morality comes into play and to a certain degree influences the law, then the result of this, which is evident from the civil law’s perception of sanctions, is that in the event one of the parties to a contract fails to perform their part of obligations, then the first cause of sanction is specific performance, which takes the form of obligating the defaulting party to perform his part of duties as agreed in the contract.

As earlier stated, the explanation of these differences can be found in the unique historical background which formed the development of each judicial system. When

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<sup>12</sup> Yehuda ADAR, Gabriela Shalev, “The Law of Remedies in a Mixed Jurisdiction: The Israeli Experience”, *Tulane European and Civil Law Forum*, Vol. 23, pp. 111-142, p. 116.

<sup>13</sup> Ugo MATTEI, “The Comparative Law and Economics of Penalty Clauses in Contracts”, *American Comparative Law Journal*, 1995, Vol. 43, p.p. 427-444, p. 440.

<sup>14</sup> Richard R. CRASWELL, “Against Fuller and Perdue”, *Stanford Law School*, Working Paper No. 183, 1999, p. 17.

studying place and purpose of each remedy in its systemic context, we can better understand its logic and function. Nonetheless, despite these differences in the two major legal systems, with regard to the logic and function of contract law, it is generally accepted in both legal systems that contractual sanctions are the measures of securing legal rights.

In line with the above, it is widely accepted fact that origins of Civil law lay with ancient Roman law, which later was affected by Germanic customs, canon law and for forth, which under the great influence of the Catholic Church and emerging legal academia transformed into the common and natural rule of right, applying uniformly to everyone. This explains why written law and its codification are the main traits of Civil law.

At the heart of Civil law is codification, all core principles are codified into a referable system which serves as the primary source of law. The French Civil Code (Napoleon Code) was enacted in 1804; German Civil Code – in 1900; The Swiss Civil Code-1907. In 1927 Turkey adopted the Swiss code, forming the Turkish Civil Code<sup>15</sup>.

All these codes above contemplated of general provisions, applicable to all types of contracts, and special norms, regulating different types of contract. For instance, both French and German laws as well as Swiss and Turkish laws ,originally considered specific performance as a primary remedy, which court had to award if the plaintiff demanded it, with the exception of cases when it could not be performed. This approach was based on the understanding of the contract as moral, and not only a legal obligation. The academic scholars widely shared such interpretation of the Civil law sanctions doctrine.

Common law on the other hand, was mostly derived from practices of the courts, in fact starting from XII century; it was developed by the Royal Courts into an institute of different forms of action<sup>16</sup>. In other words, unlike civil law that is codified, common law originated as a system of unwritten laws based on legal precedents established by the

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<sup>15</sup> Arzu OGUZ, “The Role of Comparative Law in the Development of Turkish Civil Law”, *Pace Int'l L. Rev.*, 2005, Vol. 17, Iss. 2, pp-373-386, p. 380.

<sup>16</sup> Joseph DAINOW, “The Civil Law and the Common Law: Some Points of Comparison,” *American Journal of Comparative Law*, Vol. 15, Iss. 3, 1966-1967, pp. 419-435, p. 425.

courts. Under this system, the leading remedy was and till date is damages, which initially played the role of substitute performance.

Progress of contract law in England was enhanced by Industrial revolution (1770-1870)<sup>17</sup>. Serious legal reform in Common law occurred only in XIX century, this is when equity merged with Common law of actions. The law of equity was created by the courts of Chancery in order to mitigate the harshness that common law provided to the people, this resulted at first in the general system of writs. Writs, is a legal document given by judicial or administrative bodies that order a person to perform or cease from doing certain actions. The introduction of the system of writs then provided for future development of contract law and sanctions. In particular, the merging of equity with Common law of actions, brought about the secondary remedies of equity which were derived from doctrines of cannon law. Canon law by its very nature i.e. a set of law made by church leadership, provided for the supplementary sanction of specific performance in case damages were unable to compensate for the breach of contract. As such, apart from monetary compensation, common law courts, in some instances began ordering a defaulting party to a contract to perform his part of obligations, i.e. specific performance.

It would be wrong to deny that economy and legal science, Roman law and legal customs, religious (church) and secular legislators affected both systems' development. Correlation of legal sources, process of legislative borrowing, internalization of education and trade, all together explain why different legal orders share same general principles and overall structure of remedies. To certain extent major difference between legal orders may be explained in more simplistic way from the fact that court developed Common law, while Civil law directed court practice.

## **B. Qualities and Functions of Contractual Sanctions**

Before looking at the qualities of contractual sanctions, it is important to note that the very function of contract law is to give effect to the preferences of its clients. One of the

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<sup>17</sup> Robert J. KACZOROWSKI, "Common-Law Background of Nineteenth-Century Tort Law", *Ohio State Law Journal*, (1990), Vol. 51, pp.1127-1199, p. 1141.



key traits of contracts is freedom, i.e., contractual parties have the freedom to agree on the terms of the contract and this includes the applicable sanctions in the event of breach. In that context, in order for any one sanction to be regarded as successful, it ought to contain certain qualities.

First, remedies should be regarded as mere default rules which are capable of modification by the parties, i.e the parties should have input into what consequences follow in the event of a particular breach and the form it will take. Secondly, they should be clear and simple as possible, and thirdly they should reflect commercial expectation<sup>18</sup>. These rules of successful remedies become very important, especially for parties wishing to replace the law's default rules with their own preferred regime.

With regard to the functions of contractual sanctions, it is imperative to note that contracts by their very nature have been granted a lot of power by the law. One of such power is the inherent quality to secure legal punishment or relief when another breaks his promise<sup>19</sup>. It is by this that contractual sanctions are able to be categorized according to their purpose. Classifying contractual sanctions by purpose, leads into four basic types, i.e. (1) restitutive; (2) compensatory; (3) coercion and (4) declarative<sup>20</sup>.

The restitutive function of contractual sanctions/reliefs is that they are designed to place a party suffering from a breach of contract, in as good a position as he would have been if no contract had been made and restore to this party the value of what money, item or service he parted with<sup>21</sup>. For instance, when the courts orders for restitution, it is essentially in order to restore the plaintiff to the position he or she occupied before his or her rights were violated. This relief is ordinarily measured by the defendant's gains, in order to prevent the defendant from being unjustly enriched by the wrong. The remedy of

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<sup>18</sup> Graham VIRGO, *Commercial Remedies: Resolving Controversies*, Cambridge University Press, 2017, p. 31.

<sup>19</sup> Ian R. MACNEILIAN, "Power of Contract and Agreed Remedies," *Cornell Law Quarterly*, Vol. 47, Iss. 4, 1962, pp. 495-528, p. 495.

<sup>20</sup> İbrahim GÜL, "Freedom of Contract, Party Autonomy and Its Limit Under the CISG", *HacettepeHFD*, Vol. 6, Iss.1, 2016, pp 77–102, p. 84.

<sup>21</sup> Joseph M. PERILLO, "Restitution in a Contractual Context and the Restatement (Third) of Restitution & Unjust Enrichment", *Washington & Lee Law Review*, Vol.68, 2011, pp.1007-10126, p.1007.

restitution can result in either a pecuniary recovery or in the recovery of property. Restitution has long been recognized as a retrospective form of reparation, which is to mean that it looks back at the gains a defaulting party has incurred as well as the losses suffered by the non-defaulting party, who is the plaintiff, and seeks to address or correct that injustice<sup>22</sup>.

The Compensatory function of contract comes mainly comes in the form of the relief of damages, which is generally intended to compensate the injured party for any harm he or she has suffered<sup>23</sup>. In this form of relief, money is substituted for that which the plaintiff has lost or suffered. This compensatory element is the most liberal form of functions that aims to achieve a “mutually acceptable” settlement based on the principle of “full and fair address”, in the sense that a defaulting party to a contract is not forced to perform his obligations, but at the same time the injured party is awarded something, typically money, in order to relieve the harm suffered.

With regard to coercion being one of the functions of contractual sanctions, an injunction order is one good example of this function. When issuing this type of sanction, the court commands the defaulting party to act, or to refrain from acting, in a certain way. In the event that the defaulting party willfully disobeys, he or she might be jailed, fined, or otherwise punished for contempt. Another example of the coercive function of contractual sanctions is the decree for specific performance, this type of relief commands the defaulting party to a contract to perform his or her part of a contract after a breach thereof has been established.

The declarative function of sanctions comes about when an injured party wishes to be made aware of what the law is, what it means, or whether or not a particular act is constitutional, so that he or she will be able to take appropriate action. The main purpose of this kind of relief is to determine an individual's rights in a particular situation where there

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<sup>22</sup> Sungjoon CHO, “The Nature of Remedies In International Trade Law”, *University of Pittsburgh Law Review*, Vol. 65, 2004, pp. 763-808, p.776.

<sup>23</sup> Thomas D. MUSGRAVE, “Comparative Contractual Remedies”, *University of Western Australia Law Review*, 2008-2009, Vol. 34, pp.300-372, p. 301.

is a legal controversy, the court will as such determine and outline the rights and responsibilities of the parties, without ordering anything to be done or awarding damages. Declaratory orders help to resolve disputes and prevent lawsuits, and they do have a binding effect.

Summarily, the overall function of contractual reliefs/ sanctions is to act as preventive (protective), restorative and corrective measures, which can serve independently or be complementary to each other. But in order to ensure that the contractual sanctions are able to function as is expected, they need to be protected by the various legal orders and practices. The legal environment where the contract law operates needs to be conducive to ensure proper enforcement of contractual sanctions. This is because while the preventive function of the contractual reliefs is passive until the breaching action happens. It is only when a breach occurs, that sanctions are activated. As such, corrective and restorative functions of remedy become vital through the legal enforcement, both private and public<sup>24</sup>.

In conclusion, contractual sanctions or reliefs comprise an integral part of each right and is recognized as essential to the concept of “ordered liberty”<sup>25</sup>. Noteworthy to mention, these reliefs may be granted under substantive/ material law (or contract) or procedural law (used to secure different stages of the court trial, e.g. extraordinary, provisional/ interim)<sup>26</sup>. This goes a long way in enabling and accelerating the functioning of rule of law<sup>27</sup>.

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<sup>24</sup> Paul GEWIRTZ, “Remedies and Resistance”, *Yale Law Journal*, 1983, Vol. 92, Iss.4, pp. 585- 680,p. 587.

<sup>25</sup> Ashby v White, [http://en.wikipedia.org/wiki/Ashby\\_v\\_White](http://en.wikipedia.org/wiki/Ashby_v_White).

<sup>26</sup> Michael J. CUMBERLAND, “Separate but Equal Treatment for Contract Damages”, *Arkansas Law Review*, 1967-1968, Vol. 21, p.p. 167 – 175, p. 173.

<sup>27</sup> Tracy A. THOMAS, “Ubi Jus, Ibi Remedium: The Fundamental Right to a Remedy under Due Process”, *San Diego Law Review*, 2004, Vol. 41, p. 1639.

## CHAPTER TWO

### TYPES OF CONTRACTUAL SANCTIONS

The types of sanctions that result after a breach of contract, and the reliefs an injured party is entitled to as a result of this breach has been a topic of study since time immemorial.

In this segment, the remedies which are used in Anglo-American Common Law in response to contractual breach will be compared to the remedies used in the Civil Law. In both the Common Law and Civil law they are several similar basic remedies which are available in the event of a breach of contract, for instance, damages, specific performance and termination.

Although the contractual remedies in the two systems are essentially the same, the ways in which these remedies are applied in the two systems vary considerably.

#### I. THE SANCTION OF SPECIFIC PERFORMANCE

Specific performance may be described as an order compelling a party to a contract to fulfill his obligations under the said contract<sup>28</sup>.

##### A. Specific Performance in Civil Law

In Civil law, specific performance has traditionally been the central remedy for a breach of contract<sup>29</sup>. Where a party to a contract is in default, the injured party has the right to require the party who is in breach to perform his obligations under the contract. In the event the defaulting party is a seller, or contractor, Specific performance will require the defaulting party to deliver, repair, rectify or substitute the goods or services as to what had

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<sup>28</sup> M.S.M BRASSEY, "Specific performance- A new stage for Labour's lost love", (1981), *Industrial Law Journal*, Vol. 2, pp-57-79, p 58.

<sup>29</sup> Theodore EISENBERG, and Geoffrey P. MILLER, "Damages versus Specific Performance: Lessons from Commercial Contracts" (2013), *New York University Law and Economics Working Papers*, Paper No. 334, pp 1-64, p 1.

been agreed in the contract. Moreover, in the event that the defaulting party is the buyer for instance, then the order of specific performance will be to the extent of payment or taking delivery of the goods together with any other contractual obligations, as the case may be.

In Turkey, the TCO, in Art. 227 (para 1, subpara 4), provides for the buyer's right to demand substitute goods in cases where the delivered goods are defective. The claim for substitute goods, as described above, is a form of specific performance<sup>30</sup>.

Furthermore, Art. 179/2 of the TCO also stipulates that, even where the parties have agreed on penalty that is to follow in the event a contractual obligation is unfulfilled by the determined time, or at the determined place, the injured party is in principle, still entitled to request for performance of the penalty together with the primary obligation (specific performance), unless it has explicitly waived its right<sup>31</sup>. Another example of specific performance comes by virtue of Art. 4(2) of the Turkish Code on Consumer Protection (the "TCCP"), under this Art., the buyer (consumer) is entitled to require repair<sup>32</sup>.

Generally, the relief of specific performance is keen to ensure that the terms agreed to in a contract by the parties are fulfilled, and it seems to stem from the principle of the binding force of contract to the effect that parties agreed to particular terms, and as such parties should stick to the agreement and each fulfill their obligations, failure to which, if a party does not perform, then they can be forced to do so by a court of law. This is indeed the position of most civil law jurisdictions. In countries like Germany, France, and Poland, the claim for performance is seen as the natural relief that should automatically follow, based on the fact that a valid contract exists.

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<sup>30</sup> İlker ÖZTAŞ, "Türk Borçlar Kanunu Kapsamında Taşınır Satışında Alıcının Ayıplı Satılanın Değiştirilmesini Talep Hakkı", *MÜHF - HAD*, (2016) Vol.22, Iss. 2, pp 331-364, p.332.

<sup>31</sup> Ecem CENTİYİLMAZ, *Contractual penalty under Turkish Law*, 2016, D.A 21.10.2018, <http://www.erdem-erdem.av.tr/publications/newsletter/contractual-penalty-under-turkish-law/>

<sup>32</sup> Cagdas Evrim ERGUN, *Comparative Study on the Buyer's Remedies Under the 1980 Vienna Sales Convention and Turkish Sales Law*, September 2002, D.A 25. 8.2018, [http://www.sisudoc.org/cisg/en/pdf/comparative\\_study\\_on\\_buyers\\_remedies\\_under\\_cisg.cagdas\\_evrimer\\_gun.portrait.a4.pdf](http://www.sisudoc.org/cisg/en/pdf/comparative_study_on_buyers_remedies_under_cisg.cagdas_evrimer_gun.portrait.a4.pdf)

Specific performance in French law is considered to be not only an ordinary relief available to a party in the event of breach, but in fact, the principal relief which the creditor is entitled to seek, provided that the performance of it ‘is still possible’<sup>33</sup>.

Take for example, Article 1101 of the new French Civil Code which embodies the principle of “*Pacta sunt servanda*”, which translated means “Agreements must be kept”. The principle is quite significant in contract law and it expresses the fact the contracts, lawfully entered into, have the force of law for those who made them. They ought to be performed in good faith, and cannot be revoked, except by mutual consent, or for reasons stipulated in law.

French law, as such, favors the continued existence of the contract, and this is why the relief of specific performance is widely accepted<sup>34</sup>. Take for example Art. 1184 of the 1804 FCC, set forth the primary rule that even in the event of non-performance, the agreement stays partially in force and aggrieved party has a choice to demand performance (if it is still available) or to dissolve the contract and demand damages and any other available relief. The reforms in the 2016 French Civil Code affirm the central place of specific performance as a remedy for breach of contract. Articles 1217 and 1221 state that, upon breach, the injured promisee can seek performance of the contract.

Specific performance is also the rule under German law. Section 241(1) of the German Civil Code stipulates that if one violates the terms of the contract and fails to perform their obligations as agreed, then the other party can rightfully claim performance of the same.

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<sup>33</sup> MUSGRAVE, *ibid*, p. 327.

<sup>34</sup> Copernic-AVOCATS, *Sanctions for contractual non-performance under French law*, D.A 30.8.2018, [http://www.copernic-avocats.com/wpcontent/uploads/2016/03/REMEDIES\\_FRENCH\\_LAW\\_COPERNIC-AVOCATS.pdf](http://www.copernic-avocats.com/wpcontent/uploads/2016/03/REMEDIES_FRENCH_LAW_COPERNIC-AVOCATS.pdf)

Moreover, in the event that this party fails to abide by the court decision to perform, it can be forced to do so by an official bailiff, who through a variety of processes, would take the goods or the money from the defaulting party and give it to the injured party<sup>35</sup>.

However, regardless of the fact that civil jurisdictions strongly support the relief of specific performance, there are times that this order becomes unavailable. Realistically, the sanction of specific performance cannot always be applied, for instance, if Dilek is to get married on 30 August, and the manufacturer of the wedding gown fails to deliver on that date, it would then be futile going to court and claim performance from the manufacturer of the wedding dress, as the specific date or occasion for which purpose you had entered into the contract has lapsed.

Such a case of objective impossibility not only exists if performance is only useful if it takes place before a fixed date, this concept of objective impossibility also extends to situations where performance may still be possible but performing the same would cause the defaulting party unreasonable effort or extraordinarily high expense. Take for example, a person gets into a contract to sell their ring to someone else, but before they can give it to the buyer, the seller accidentally drops the ring into the river. In such an event, no reasonable person would require the seller of a ring who accidentally dropped it in the river to dig it up, even though this would technically be possible, but it is at the expense of a large sum of money.

In light of the above considerations and others, Section 275 of the German Civil Code sets forth circumstances where a debtor is relieved from his duty to perform: 1) a party cannot request specific performance if performance is impossible for the defaulting party or any third party; 2) it requires expenses, manifestly disproportionate to the interests of the injured party; 3) it is unreasonable or of personal nature.)<sup>36</sup>.

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<sup>35</sup> John A TRENOR, *Guide to Damages in International Arbitration*, 2016, Law Business Research Ltd, London, p. 13.

<sup>36</sup> Clare CONNELLAN Et. Al, *Compensatory Damages Principles in Civil- and Common-Law Jurisdictions – Requirements, Underlying Principles and Limits*, D. A 2.9.2018,

The reason behind these exceptions is that, if a court is to allow a claim for performance in some of these cases, then not only would this turn the defaulting party into some sort of slave, but it is also difficult to believe that an unwilling party will in fact perform to the best of its abilities when being forced to do so.

Turkey also elaborates or rather sets limits on the extent the remedy of specific performance will be available. The Law in Turkey mentions of certain instances where a decree for specific performance will normally be refused. For instance, the buyer, in a contract of sale of goods, cannot automatically claim delivery of substitute goods in the events of defective goods, i.e., a buyer cannot demand for substitute goods if the goods are perished or substantially damaged for a reason attributable to the buyer.

Furthermore, in Turkey, this claim for delivery of substitute goods only happens when the seller's liability for defects is triggered, this is because, except for cases where the seller is grossly negligent, the provisions of the TCO regarding liability of the seller due to defects are not mandatory, as an agreement may be concluded within the scope of contractual freedom in order to exclude or limit this liability<sup>37</sup>.

Also, this right of replacement of the defective goods, which is an optional right vested to the buyer under Article 227 of the TCO, is only exercisable for generic obligations<sup>38</sup>.

Lastly, another exception or limit that has been put for an order of specific performance is that such a claim for specific performance should be on performance that can be reasonably be expected. The TCCP, similar to the other laws in most of the civil law

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<https://globalarbitrationreview.com/chapter/1151600/compensatory-damages-principles-in-civil-and-common-law-jurisdictions-%E2%80%93-requirements-underlying-principles-and-limits>.

<sup>37</sup> Firat COSKUN, *Turkey: Seller's Liability Due To Defects In Purchase Agreements*, 27 November 2017, <http://www.mondaq.com/turkey/x/649894/Product+Liability+Safety/Sellers+Liability+Due+to+Defects+in+Purchase+Agreements>

<sup>38</sup> COSKUN, *Ibid*



countries, states that the right to require repair, a form of specific performance, is based on the assumption that the request is not unreasonable<sup>39</sup>.

## **B. Specific Performance in Common Law**

Although the general availability of the claim for performance seems logical in view of protecting or promoting the aim of the contract by holding a party to its promise, Common law adopts a different standpoint. Under Common law, the normal action in the event of breach of contract is damages, while the remedy of specific performance becomes the exception<sup>40</sup>.

There are several reasons for this radically different position adopted by Common law and Civil law, but in essence, the reason behind the common law position on the remedy of specific performance finds its origins in an alternative view of the contract itself. Oliver Wendell Holmes, a famous American judge and jurist, best expressed this when in 1881 he wrote that “. . . *the only universal consequence of a legally binding promise is that the law makes the promisor pay damages if the promised act does not come to pass. In every case it leaves him free to break his contract if he chooses.*”

Unlike the Civil law’s perception of a contract i.e, as a moral conception, the Common law’s position, and as aptly put Jurist Holmes above, views a contract, as an economic device: that the main reason behind people concluding contracts is so as to increase their well-being and success, and as such in the event of a breach of breach of contract, then a relief putting the injured in the financial position in which it would have been had the contract been properly performed, is just as good and the most suitable<sup>41</sup>.

Nonetheless, despite Common law’s general position above, it does recognize that there are certain situations where the remedy of specific performance should be available. This is why, under the laws of equity, it is a long-standing principle that where the remedy

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<sup>39</sup> Aydin ZEVKLILER, *Ozel Borc Iliskileri, [Special Types of Obligations]*, Ankara, 1998, 2<sup>nd</sup> Ed., p. 102.

<sup>40</sup> Jan SMITS, *The Law of Contract*, 2014, Springer International Publishing, Switzerland p. 67.

<sup>41</sup> ZEVKLILER, *Ibid*, p. 102.

of damages may sometimes be “inadequate,” and it is in such circumstances that courts grant a claim for performance.

In particular, in the case of contracts concerning specific goods (such as land, works of art, or other objects having unique qualities), the court allows the creditor to force the other party to perform in specie<sup>42</sup>.

Take for example, even though the English SGA puts in place stringent restriction or limits to the application of specific performance, section 52(1) of the English SGA) stipulates that the sanction or an order for specific performance is made available only with reference to cases concerning “ascertained” goods. Ascertained goods are items that are clearly identified and agreed at the time of contract” formation<sup>43</sup>.

Goods identified and agreed upon at the time of the making of the contract of sale are called ‘specific goods’ or ‘ascertained goods’ is used in the same sense as ‘specific goods,’ For example, where A agrees to sell to B a particular radio bearing a distinctive number, there is a contract of specific or ascertained goods.

It is only in such limited circumstances that, if such a radio bearing the distinctive number is not given to the seller, then the relief of specific performance becomes available under the English law.

On the other hand, where goods are considered to be unascertained equitable remedy as specific performance cannot be awarded, as established by leading cases in common law, such as the case of *Re Wait* <sup>44</sup>.

Unascertained goods are those not specifically identified at the time of entering a contract, take for instance a contract to deliver 100 chairs, where the contract does not give

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<sup>42</sup> SMITS, *ibid*, p. 69.

<sup>43</sup> Peter A. PILIOUNIS, “The Remedy of Specific Performance, Price Reduction and Additional Time under the CISG: Are these worthwhile changes or additions to English Sales Law?”, *Pace International Law Review*, 2000, p. 1 – 46, p.33.

<sup>44</sup> Law teacher.net, *Reforms of the Sale of Goods* , February 2019, D.A 4.10.2018, <https://www.lawteacher.net/free-law-essays/commercial-law/reforms-of-the-sale-of-goods-commercial-law-essay.php?vref=1>.

a specific description then this chairs fall under the group of unascertained goods as the other party can deliver any kind of chairs).

This means that, where the goods in question are goods that are readily available on the market, such as, potatoes, bananas, water, oil, steel and plastics then the remedy of specific performance becomes unavailable in most of the Common law countries. This position is in contrast to civil law countries, where it is beyond doubt that the buyer of such goods i.e. mangoes, oranges, can claim delivery from the seller, regardless whether the item has unique qualities or readily available. In Common law, however, the buyer has to be content with a claim for damages as these goods are not unique and he can easily find them elsewhere.

They are several other legislations that adhere to this view, such as in the United States of America. The USA position, in principal, is that a buyer has right to receive identified goods, especially if he is unable to find substitute or such effort is not justified under reasonable circumstances. §2-716 UCC, states that specific performance can be affected by the court where the goods are unique or in other proper circumstances; additionally court may order payment of the price, damages or other relief as my deem just.

The doctrine of specific performance in most common law jurisdictions is guided by two subsidiary principles: 1) damages are presumed inadequate when the subject matter of the contract is unique and 2) prevention of specific performance in respect of services of personal nature or causing undue judicial supervision<sup>45</sup>.

In short, under Common law, this remedy is considered to be an exceptional one, which is discretionary in nature. It is not a remedy which is usually sought by a plaintiff, nor is it frequently awarded by the court, however where the court is of the stand that

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<sup>45</sup> Maria BELETSKAYA, *Development of the Contractual Remedies in the International Trade: Comparative Analysis and Example of Implementation in Standard Construction Contracts*, Master's Thesis, p.36.

damages would really not be sufficient then they may grant an order of specific performance<sup>46</sup>.

### **C. Specific Performance in International Unification Sources**

The CISG adopts the general civil law principle that the injured party is entitled to require performance<sup>47</sup>.

Various articles of this law embody the principle of respect for the contract (*pacta sunt servanda- agreements must be kept*). Take for instance Article 46(1) of the CISG, which stipulates that an injured party may require performance by the defaulting party of his obligations as is agreed in a contract. Also, Articles 46(2) and (3) go ahead and provide for the right to require delivery of substitute good and the right to require repair.

In essence, the CISG acknowledges that, after a breach of contract, ‘the injured parties principal concern is often that the defaulting performs the contract as he originally promised<sup>48</sup>.’ Similar to civil law, the CISG holds parties to their promises and duties, and does not readily offer the breaching party the option to exchange off his obligation by forcing the aggrieved party to accept a monetary substitute for actual performance<sup>49</sup>.

The reason behind CISG selecting this approach contracts, was calculated and not accidental was no accident. Given the nature and aspects that surround an international contract, including the distance involved between the parties, as well as taking into appreciation the time, effort and risk involved in such a transaction, as such, the right to require performance of obligations as is agreed under contract is invaluable and of paramount to the parties.

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<sup>46</sup> Guenter Heinz TREITEL, Specific Performance in the Sale of Goods, Journal of Business Law, 1966, Vol. 211, p. p. 211-231, p. 224.

<sup>47</sup> Guenter TREITEL, *Remedies: A Comparative Account*, 1988, 1<sup>st</sup> Ed., Clarendon Press, Oxford England, p.73.

<sup>48</sup> Secretariat COMMENTARY, ‘Article 46 of the CISG’, *United Nations Conference on Contracts for the International Sale of Goods*, Vienna, (10 March – 11 April 1980)Official Records,UN Documents, p. 38.

<sup>49</sup> Johan ERAUW and Harry FLECHTNER, ‘Remedies under the CISG and their Limits to their uniform Character’, *In Petar Šarcevic- International Sale of Goods Revisited*, Kluwer Law International Publishers, 1<sup>st</sup> Ed, 2001, pp 35-76, p 48.

In order to create a compromise and bring balance between civil law countries, which tend to grant specific performance more frequently, and common law countries, which tend to view specific performance as a secondary remedy, the CISG under Article 28 also states a limitation to the application of Specific performance. Art. 28 provides for a right of a party to require specific performance of any obligation by the counterparty, but a court is not bound to issue this relief, unless it would do so under its own law in respect of similar contracts<sup>50</sup>.

Another international source of law is the Draft Common Frame of Reference (DCFR). This is essentially an Academic text for European Institutions which contains Principles, Definitions and Model Rules of European Private Law. It has been approved by the European Commission and now has achieved a status such that it is being consulted by law reformers and judges.

The DCFR divides the sanctions that should follow in the event of breach into monetary and non-monetary obligations. In the case of monetary sanctions, it advocates for the right to damages, as is stipulated under Art. 3:302 DCFR, on the hand, in the non-monetary obligations, it embraces the relief of specific performance as seen under Art. 3:302 DCFR.

Similar provision can be found in The Principles of European Contract Law (PECL) Art. 9:101 and 9:102<sup>51</sup>. In addition, Art. 9:102 (2) of the PECL stipulates certain exceptions as to when specific performance cannot be obtained, for instance where performance of this obligation would be impossible, unlawful, or the performance of such obligation would cause the obligor unreasonable effort or expense, or further, in circumstances where the aggrieved party may reasonably obtain performance from another source.

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<sup>50</sup> United Nations, *United Nations Convention on Contracts for the International Sale of Goods*, 2010, D.A 2.12.2018, <http://www.uncitral.org/pdf/english/texts/sales/cisg/V1056997-CISG-e-book.pdf>

<sup>51</sup> Gerard De VRIES, "Right to Specific Performance: Is there a Divergence between Civil- and Common-Law Systems and, If So, How Has It Been Bridged in the DCFR?", *European Review of Private LawJournal*, (2009), Vol. 4, p.p. 581-597, p. 588.

Also, where the performance consists of providing services or work that is of a personal character or depends upon a personal relationship, then the remedy of specific performance may not be obtained, then the courts are likely not give an order of specific performance.

The exception on contracts which require services of personal nature or specific personal qualities is stipulated in Art. 9:102 of the PECL which states: “*the performance consists in the provision of services or work of a personal character or depends on a personal relationship.*” For example, a music company cannot force a musician like Oğuzhan Koç, to make a record to the best of its artistic ability, another example is that the organizers of the Beşiktaş J.K. Football Team cannot make their player participate in a match. This does not mean that in the event a breach occurs in contracts with artists or sportspeople, then a party cannot receive any solution or relief, they can, but the other party can only bring a claim for damages or termination in case of breach of the contract and so forth.

Further, Art. 8:108 PECL stipulates that the court may excuses non-performance by the defaulting party, on the basis that the breaching party encountered unforeseen impediment beyond its control and notified another party within reasonable time, in such instances Art. 8:101 (2) PECL states that the aggrieved party may claim other reliefs but not claim performance and damages (similar provisions are stipulated by DCFR (III, Art. 3:104 and Art. 3:101 (2) respectively).

#### **D. Intermediate Conclusion**

Specific performance is the relief that goes to the very core in preserving a contract, and corresponds to the claim one person has against another person i.e. the affirmative acts agreed in a contract. In all cases therefore, where a party is bound to do such affirmative acts, the other party has the claim for specific performance<sup>52</sup>. Hence a party can sue for the

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<sup>52</sup> Walter NEITZEL, “Specific Performance, Injunctions, and Damages in the German Law ” *Harvard Law Review*, Vol. 22, Iss. 3, 1909, pp. 161-181, p. 170.

delivery of the thing purchased, for the construction of the house, for the rendering of services and so forth.

Comparative essays and studies often state that one of the fundamental differences between the common law and civil law with regard to obligations lies in the remedy of specific performance. This is because, as elaborated above, specific performance is the primary relief in civil law in the event of a breach of contract, and this largely based on the view that the innocent party has a right to fulfillment of the contract as had been agreed. Under Civil law, where performance has been ordered then non-compliance with this decree of specific implement is punishable by various sanctions, including imprisonment and monetary sanctions<sup>53</sup>. On the other hand, in the common law jurisdiction, specific performance is a secondary remedy, given only in exceptional circumstances and the primary remedy being a claim for damages<sup>54</sup>.

The advantage of an order for specific performance is that the innocent party gets exactly what it contracted for and there is no need to mitigate loss. On the other hand, several objections against specific performance have been put forth including that the enforcement process of this relief is very intrusive and coercive and sometimes fails to achieve the desired result, in the sense that a party is mandated to perform his obligations and sometimes even with order of specific performance, a party fails to comply and this constitutes to a disgrace of court and several other consequences follow such as imprisonment, civil fine or both<sup>55</sup>.

## II. THE SANCTION OF DAMAGES

The main purpose of contractual remedies is to place a disappointed party in as good a position as he would have enjoyed had his promisor performed. In order to achieve

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<sup>53</sup> Scottish Law COMMISSION , *Remedies for Breach of Contract*, April 1999, Discussion Paper No. 109, p. 50

<sup>54</sup> Walter NEITZEL, "Specific Performance, Injunctions, and Damages in the German Law " *Harvard Law Review*, Vol. 22, No. 3 (Jan., 1909), pp. 161-181, p. 165.

<sup>55</sup> Melvin A. EISENBERG, "Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law", *California Law Review*, (2005), Vol. 93, No.4, p.p. 975 – 1050, p. 1021.

this, Contract law has developed the compensation goal, which is essentially requiring the breaching party to pay damages for the loss and harm suffered by the other party<sup>56</sup>.

Damages refers to money paid by the defaulting party to a contract, to the other party of the contract, and the most common form of damages is compensatory damages, which are essentially damages paid to directly compensate the non-breaching party for the value of what was not done or performed<sup>57</sup>. Compensatory damages are not aimed to punish a party but rather to make the injured party suffering from the breach “whole” again.

### **A. Damages in Civil Law**

The general position under civil law is that a claim for damages becomes available only when the party in breach was at fault or can at least be held responsible for the nonperformance<sup>58</sup>.

Art. 1231-1 of the French Civil Code states that no damages are due when the person who is to perform was prevented from doing so by an unforeseeable irresistible force (force majeure). Force majeure is unavoidable accidents, beyond one control and includes acts of God such as floods, acts of man such as fire and so forth.

As such, in most Civil law countries it has be proved that the defaulting party is indeed at fault, and in most cases, a party is freed from any compensatory liability if it can prove that it used its best efforts in performing the contract<sup>59</sup>.

Nonetheless, in all cases where a defaulting party cannot justify his nonperformance by reference to an external cause which cannot be imputed to him, even if there was no bad faith on his part, then such party is to pay damages.(Non-performance could take the form

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<sup>56</sup> Alan SCHWART, “The Case for Specific Performance”, *The Yale Law Journal*, (1979) Vol. 89, No. 271, pp.197 -306, p. 271.

<sup>57</sup> LUMEN, *Legal Remedies: Damages*, <https://courses.lumenlearning.com/masterybusinesslaw/chapter/legal-remedies-damages/>

<sup>58</sup> SMÍTS, *Ibid*, p. 68.

<sup>59</sup>Vernon PALMER, *Mixed Jurisdictions Compared: Private Law in Louisiana and Scotland*, 2009, Edinburg University Press, p. 249.



of performance that is defective or partial in nature<sup>60</sup>). This principle is indicated by Article 1231-6 of the FCC, which states that the debtor is required, should the occasion arise, to pay damages and interest, whether by reason of the non-performance of the obligation, or whether by reason of the lateness of the performance, if he fails to prove that the non-fulfillment is the result of a cause of which he is not responsible.

France has also put in further parameters that ought to be complied with before the sanction of damages is allowed. For instance the general rule under the FCC, as is stated under Art. 1231 the damages shall only be due if the debtor has first been served notice to perform within a reasonable period of time<sup>61</sup>.

Noteworthy to mention is that damages, especially compensatory damages, are payable by the debtor whenever the creditor has suffered a loss as a result of the non-performance by the debtor of his contractual obligations. Accordingly, where the relief of damages is awarded, its purpose is to put a creditor in the position he would have been before the default i.e. the creditor receives ‘full compensation for the loss resulting from the breach of contract.

In fact damages are often referred to amongst French jurists as “exécution en équivalent.” This phrase literally means “equivalent performance”, but it may also be translated as “substitute performance”<sup>62</sup>.

Art. 1231-2, states that the damages due to the injured party are with regard to the loss that was made as well as the gain that was deprived. This is the principle of full compensatory damages, which traditionally takes the two forms, (i) the actual loss incurred by the creditor as a result of nonperformance and (ii) the profit, or ‘gain’, of which he has been deprived, popularly known as the loss of profit, this represents the profits which the

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<sup>60</sup> Thomas D MUSGRAVE, “Comparative Contractual Remedies”, 2009, *UWA Law Review*, Vol.34, pp. 300-372, p.350.

<sup>61</sup> Sanctions for contractual non-performance under French law, [http://www.copernic-avocats.com/wp-content/uploads/2016/03/REMEDIES\\_FRENCH\\_LAW\\_COPERNIC-AVOCATS.pdf](http://www.copernic-avocats.com/wp-content/uploads/2016/03/REMEDIES_FRENCH_LAW_COPERNIC-AVOCATS.pdf)

<sup>62</sup> MUSGRAVE, *Ibid*, p.350.

creditor would have obtained had the debtor performed his obligations as required under the contract.

The Latin terms of the two categories of loss above are, *damnum emergens* and *lucrum cessans* respectively, and were originally formulated at Roman law. These two categories were later accepted by French jurists as the basis upon which to measure damages for breach of contract, and several other jurisdictions<sup>63</sup>.

Germany to a large extent also applies similar principles as the French. Pursuant to BGB, a party may claim compensation for the breach of duty arising out of the obligation to perform unless obligor is not liable for the failure (§280(1) BGB)<sup>64</sup>. Also, BGB avoids the term “non-performance”, because there has been debate along the line of deficient or partial performance is not complete, but still performance. As such, the law in Germany uses “breach of duty” to mean that provided a party does not fulfill the agreed terms in whatever manner, the other party can claim damages.

Moreover, in the new German Statute on Modernization of the Law of Obligations, damages may be sought only if certain conditions are met<sup>65</sup>. Most important of conditions is that the buyer is entitled to compensation if the vendor is responsible for the damage, i.e. the damage was caused by at least negligent actions on the vendor’s part.

Under Turkish Law, a party can claim for pecuniary and non-pecuniary damages, the non-pecuniary damages include both actual damages and loss of profit<sup>66</sup>. Pecuniary damages are damages that can easily be ascertained, such a property repairs, non-pecuniary damages on the other hand do not have a discernible, quantifiable monetary value such as loss of quality of life.

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<sup>63</sup> Christian LARROUMET, *Droit Civil: Les Obligations, Le Contrat Tome III*, 2003, Paris Economica, 5<sup>th</sup> Ed, p. 715.

<sup>64</sup> Reinhard ZIMMERMANN, *Breach of Contract and Remedies under the New German Law of Obligations*, 2002, <http://www.cisg.law.pace.edu/cisg/biblio/zimmerman.html>

<sup>65</sup> John Y. GOTANDA, “Damages in Lieu of Performance because of Breach of Contract” (2006), *Working Paper Series* 53, p.14.

<sup>66</sup> Hüseyin Can AKSOY, *Impossibility in Modern Private Law: A Comparative Study of German, Swiss and Turkish Laws and the Unification Instruments of Private Law*, 2014, Springer International Publishing, Switzerland.

Additionally, Turkish law allows the buyer of defective goods to combine a damages claim with another form of remedy. Under Article 205(2) of the TCO stipulates that the buyer has right to claim damages in the case of rescission of the contract. However, this provision is considered by Swiss and Turkish scholars as well as by Turkish Supreme Court as not limited to rescission of the contract but being applicable to other remedies as well<sup>67</sup>.

## **B. Damages in Common Law**

Under Common Law the primary remedy for breach of contract has traditionally been, and continues to be, that of damages.

Under the early Common law system, the laid down mechanism dealing with contractual matters, prescribed an award of damages as the only relief available to a plaintiff. This award would take the form of an order from the court that the defaulting party pays the injured party a specific amount of money for breach of the terms and conditions. It was only up until the 15th century, when the concept of contract began to expand and widen its scope, and was no longer limited to debt or land transaction, that the courts under Common Law, particularly the Court of Chancery, began to intervene more and more in cases of breach of simple contracts to provide equitable reliefs, such as specific performance.

Nonetheless, the remedy of damages continues to be the most frequently awarded relief by the Courts. Following the Anglo-American rule of strict liability, a defaulting party is obliged to be liable for all the losses arising from his breach of contract, irrespective of his fault<sup>68</sup>.

Unlike Civil Law, the position in Common law is that it does not generally look at whether the breach that occurred was caused by the defaulting party's fault or not, provided a party has not performed their obligations as agreed, they are held liable, unless of course

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<sup>67</sup> C.YAVUZ, *Saticinin Malin Ayiplarindan Sorumlulugu, [Liability of the Seller for Defective Goods]* Istanbul, 1989, p. 155.

<sup>68</sup> Hugh BEALE, *Chitty on Contracts*, 2008, Edtn. 30, Sweet & Maxwell Ltd, United Kingdom, p. 99.

it as an act of *force majeure*, which means acts of God, i.e. floods, earthquakes and so forth.

The purpose of this strict application of the remedy of damages is to put the aggrieved party, as much as possible, and as far as money can do, in the same financial position as if the breach had never occurred and the contract had been properly performed. The aggrieved party has the right to be fully compensated for all the disadvantages resulting from the other party's breach and for his loss of the benefit from the bargain<sup>69</sup>. Both the actual loss suffered as a result of breach as well as loss of profits are compensable.

Case law, which is one of the main foundations of Common law, also brings about the concept of remoteness in the relief of damages.

Under the rules of remoteness of damage in contract law, which is set out in the case of *Hadley vs. Baxendale*, a claimant may only recover losses which may reasonably be considered as arising naturally from the breach or those which may reasonably be supposed to be in the contemplation of the parties at the time the contract was made<sup>70</sup>.

Underlying the judicial acceptance of remoteness, is the reason that it would be too 'harsh' to hold a defaulting party liable for the unforeseeable consequences of his breach of contract<sup>71</sup>. The means that the loss a party suffered, and is claiming damages must be foreseeable, and not merely as being possible, but as being not unlikely.

Also, there exist different types of losses through which compensation can be claimed. These include: loss of bargain, reliance loss, discomfort or disappointment, inconvenience, diminution of future prospects, speculative damages and liquidated damages.

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<sup>69</sup> Allan E. FARNSWORTH, 'Damages and Specific Relief', *American Journal of Comparative Law*, 1979 Vol. 27, Iss. 2-3, pp. 247-253, p.250.

<sup>70</sup> E-law RESOURCES, *Remedies in contract law*, D.A 12.1.2019, <http://e-lawresources.co.uk/Contract-remedies.php>

<sup>71</sup> Cristian PAZIUC, "Remoteness Of Damage In Contract And Its Functional Equivalents: A Critical Economic Approach", *UCL Journal of Law and Jurisprudence*, (2016) Vol. 5, Iss. 1, pp87-115, p 88.

Reliance loss, occurs where it is difficult for an injured party to quantify the position he would have been if the contract would have been performed, in such instances he may claim, and it is possible for such party to recover expenses incurred in reliance of the contract being performed (Reliance loss). The other type of loss which is Discomfort and /disappointment, can only be claimed where enjoyment was part of the bargain of the contract for instance a holiday package or any form of entertainment agreement a party enters to. This most commonly seen in holidays which fail to meet the standard the party who signed and paid for such holiday was led to believe would be enjoyed.

The other form of damages is Inconvenience, and it rises where the claimant has been put to physical inconvenience rather than anger or disappointment that the defaulting party has not met his contractual obligation, in some of these cases, the court may award a sum to reflect such inconvenience.

Diminution of future prospects is another form of loss where a party can claim damages, this is where a breach of contract adversely affects the claimant's future prospects, for example a contract promising training and qualifications, a sum can be awarded to reflect the loss.

Lastly, it is important to note that under common law, damages are awarded subject to deductions for any failure to mitigate or contributory negligence found on the part of the one who brought the case<sup>72</sup>.

### **C. Damages in International Unification Sources**

The CISG PECL, DCFR, and UNIDROIT embody the principle of compensatory damages being awarded to a party of a contract that has suffered a breach. These international unification sources have very similar rules with a few differences.

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<sup>72</sup> Clare CONNELLAN, Et.al, *Compensatory Damages Principles in Civil and Common Law Jurisdictions: The Guide to Damages in International Arbitration*, Law Business Research Limited, 2018, p. 12.

The remedy of damages is for example, embodied under Art. 9:501 of the PECL and Art. 3:701 DCFR, they essentially entitle an injured party to recover damages for nonperformance, unless default is excused.

Article 74 of the CISG, stipulates the basic rule for calculating damages. The first part of Article 74 states that: ‘Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach’. This is generally considered as a reflection of the principle of full compensation where a party is compensated not only for the actual loss suffered by a result of the other failing to perform the contract, but also the profit one would have incurred had the contract been performed as agreed.

In similar fashion like the CISG, both the PECL and DCFR also secure expectation interest (Art. 9:502 PECL and Art. III-3:702 DCFR), covering suffered loss and deprived gain, in line with the principle of full compensation.

Under all these laws, namely the CISG, PECL and DCFR, recovery or rather damages is only available when loss is suffered<sup>73</sup>. Loss in both cases includes future loss, which is reasonably likely to occur, and also non pecuniary loss or economic and non-economic losses. Economic loss is explained by some of the unification sources to include loss of income or profit, burdens incurred, and reductions in the value of property while non-economic loss, embraces pain and suffering and impairment of the quality of life.

The second part of Article 74 of CISG sets forth the general principle by which it measures liability in the event of breach. It states that: ‘Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of the contract’. This specifies the foreseeability rule as a method to limit the breaching party’s liability under the CISG.

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<sup>73</sup> European COMMISSION, *Art. III-3:701 DCFR*, D.A 3.2.2019, [https://ec.europa.eu/info/policies/justice-and-fundamental-rights\\_en](https://ec.europa.eu/info/policies/justice-and-fundamental-rights_en)

The same Foreseeability test is also prescribed by Art. 9:503 PECL and Art. III-3:703 DCFR. However in case of PECL and DCFR (and UNIDROIT principles) the measure for liability is simply loss which the breaching party “foresaw or reasonably should have foreseen at the time of conclusion of the contract as likely result of its non-performance”.

It is also noteworthy to mention that under the DCFR there is a general entitlement to damages for loss caused by the other party's unexcused non-performance, without any reference to a requirement of fault. This means that it does not matter whether the non performance of obligations was caused by a fault of his or not, the relief of damages continues to exist<sup>74</sup>.

#### **D. Intermediate Conclusion**

Generally, the purpose of such damages is to place the claimant in the position he would have been in had the contract not been breached, as such the party claiming the breach of contract (the plaintiff) must prove that it has suffered loss or damage as a result of the defaulting party's (defendant) breach.

Generally, the party seeking damages must be able to explain within reason how much loss he has suffered as a result of the breach. If he cannot articulate with any degree of certainty and if the damages are really speculative then such party will be entitled to nominal damages and that's all.

As we have earlier elaborated, different types of law adopt a wider definition of losses to include economic or non-economic losses, actual loss suffered as a result of the breach as well as loss of profit,. Loss of profit falls under the group called expectation damages. Expectation damages are meant to put the other party in the position they would have been in had the contract been fulfilled. A part can thus claim for all or any of this and courts will then make analysis of which of these damages a party ought to be granted.

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<sup>74</sup> European COMMISSION, Ibid.

The award of damages compensates the injured party for his loss suffered, or in legal terms, places such party in the same situation, insofar as money can do so, he would have been in if the contract had been performed. Thus, an award of damages cannot place the injured in a better position than he would have been in had the contract been performed.

According to the principle of contract law, in the case of a breach of contract, the innocent party must take steps to minimize the loss by breach of contract (mitigation), and the profits gained from such action shall be calculated in the compensation for damages, and that such profits should not be reimbursed that exceed the initial profit (principle of compensatory).

In some cases, there is an express term in a contract requiring a party, or all parties, to mitigate their loss following breach. But even without such a term there is a “duty” on the part of a party claiming damage to mitigate its loss, failing which their damage will be reduced<sup>75</sup>.

The mitigation principle may lead to a reduction in the plaintiff's damage for failure to mitigate. At the same time it may also affect the quantification of damage where the plaintiff has taken reasonable steps to mitigate. This is because the taking of reasonable steps to mitigate any loss may actually increase the plaintiff's loss, and the additional amounts will be allowed as part of damage if the plaintiff's actions were reasonable. On the other hand, where a party aggrieved by a wrong fails to minimize the loss or has contributed to the occurrence of the loss, the recoverable damage may be limited by the duty to mitigate loss or by a similar principle available under the applicable law<sup>76</sup>.

It is important to note that while this duty for a party to minimize its losses as a result of the counterparty's breach of contract is deeply ingrained in common law as a party cannot easily recover losses that it could have avoided through reasonable action, civil law jurisdictions on the other hand have not fully embraced or developed this doctrine of

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<sup>75</sup> Edmund FINNANE, *Remedies-Contract Law: a practical guide*, 2013, p.17.

<sup>76</sup> FINNANE, *ibid*, p.18.



mitigation, mainly due to the reason mentioned early on to the effect that civil law favors specific performance over compensatory damages, at least in theory.

Further, while damages puts a party in a position where he would have been had the contract been performed as agreed, there are several limitations on the right of an aggrieved party to get contract remedies for a breach besides any limitations fairly agreed to by the parties. The damages suffered by the non-breaching party must be reasonably foreseeable.

Also, in circumstances where a person enters into a contract that contains a limitation on her right to damages in case the other side breaches, then unless the limitation is unreasonably excessive and unfair, a party loses the right to claim for damages. Sometimes parties are required from their agreement, to make an election of remedies: to choose among two or more possible bases of recovery. If the remedies are really mutually exclusive and one is chosen, then it goes without saying that the aggrieved party loses the right to pursue the others. At the same time, a person is always free not to pursue any remedy at all for breach of contract; as in some circumstances it may be strategically or economically smart, take for instance where the legal costs, in terms of lawyers and court fees, will be more than the amount claimed<sup>77</sup>.

Finally, despite these different mentalities of common law and civil law, both legal traditions come close in the practical results that they reach. For instance, despite the fact that under common law the mere fact of nonperformance gives rise to liability in damages and it does not matter whether the party was at fault or not, the common law courts, through case law, have introduced and developed the concept where for a relief of damages to be awarded, the losses must be “within the reasonable contemplation” of the parties. Thus, if a claimant's losses are too remote, damages cannot be recovered, and in this manner you find several cases where the defaulting party gets spared from having to pay some damages. Likewise, in civil law jurisdictions, for a claim of damages to hold, a party must show that the part in breach was at a fault, and by this rule the chances of this relief of

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<sup>77</sup> Don MAYER, *Limitations on Contract Remedies*, D.A 13.2.2019, [https://saylordotorg.github.io/text\\_law-for-entrepreneurs/s19-05-limitations-on-contract-remedi.html](https://saylordotorg.github.io/text_law-for-entrepreneurs/s19-05-limitations-on-contract-remedi.html)

damages to be rendered reduce considerably, however in order to combat this and create a balance, some courts in civil law countries make use of the concept of implied condition in order to hold the debtor liable even though there was no fault on its part. They can do this by implying that the seller for instance has given a guarantee that the goods it sold are fit for its purpose, and failure to do by such condition, then he ought to pay damages.

In conclusion, it is also important to note that the main reason behind the relief of damages is that they are designed to compensate the innocent party for losses by the breach of contract rather than to punish the defendant.

### **III. THE SANCTION OF TERMINATION**

It has been colorfully said that terminating the contract is ‘the hardest sword that a party to a sales contract can draw if the other party has breached the contract’<sup>78</sup>. It can happen that a party to a contract loses all confidence in its counterpart or for any other reason whatsoever, simply wants to get rid of the contract, meaning that it is no longer wants to be bound to it. In such circumstances, then terminating the contract and releasing both parties from their obligations under it (subject to any damages that may be due) certainly is an appropriate remedy<sup>79</sup>.

#### **A. Termination in Civil Law**

Based on principle *pacta sunt servanda*, Roman law never recognized right to termination of contract, and looking at the old version of the laws in many civil law countries, i.e the Old German Law, they did not contain a general statutory right to

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<sup>78</sup> Ulrich MAGNUS, ‘The Remedy of Avoidance of Contract under CISG – General Remarks and Special Cases’, 2005, *Journal Of Law And Commerce*, Vol.25, Iss. 1, pp. 423- 436, p.423.

<sup>79</sup> Daniel FRIEDMANN, ‘The Performance Interest in Contract Damages’ , 1995, *Law Quaterly Review*, Vol. 111, pp 515-650, p.628, 629.

termination<sup>80</sup>. However, with time, and to bring the laws in close proximity to international contract law sources, this relief is now more available.

Previously in France, under the old French law, termination of a contract was only an order the court could give, parties had no right to terminate a contract by themselves in the event of breach; only the court could make this decision.

However, following the reforms in the FCC, judicial termination is one of three options available to the injured party that are listed in Art. 1224; the others are termination pursuant to a right in the contract and self-help termination.

In short, the relief of termination has been more readily available to the effect that a party, can now terminate the contract where the breach is 'sufficiently serious', simply by notifying the defaulting promisor. The aim is to make it quicker, easier, and cheaper for the injured party to terminate. This can be attributed to a desire to promote economic efficiency ('efficacité économique') in French law<sup>81</sup>.

Further under the new French regime, several safeguards have been put in place by Art. 1226. First, in the event of breach, the injured party must give notice to the other party, notifying him of the breach and requesting that performance be done within a reasonable period of time, failing which termination will follow. This gives the defaulting another chance to comply and perform his obligations. Second, if the defaulting promisor still continues to be on breach at the end of the period, the injured party must give him a further notice that the contract has reached its end, stating the grounds for termination.

It is also important to note that French law gives significant importance to the principle of good faith, as such; the defaulting party can invoke good faith in order to protect himself against termination without good cause. Where a defaulting party challenges the termination, the court can deny the relief and make such orders to the effect

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<sup>80</sup> Reinhard ZIMMERMANN, *Breach of Contract and Remedies under the New German Law of Obligations*, 2002, p.15, <http://www.cisg.law.pace.edu/cisg/biblio/zimmerman.html>

<sup>81</sup> Rowan SOLENE, "The New French Law of Contract", *International & Comparative Law Quarterly*, 2017, p. 15,

that the contract remains on foot i.e., granting the defaulting party a period of grace in which to perform.

Worthy to be mentioned is that a court order for resolution of contract annuls it retrospectively as it has never been signed and provide for mutual restitution. However when the contract is successive or continuous in nature (e.g. lease) resolution will not be retroactive<sup>82</sup>.

As above mentioned, Roman law never recognized the right to termination of contract, and looking at the old version of BGB, it did not contain a general statutory right to termination<sup>83</sup>. With time, the concept of removing a party from their responsibilities under the contract began, and even then, at the early days, where a party terminated a contract (meaning putting an end to the contract) the law derived from German General Commercial Code 1861, did not allow this party to claim damages<sup>84</sup>.

Amendments to BGB have changed this principle. Pursuant to Sec. 323 BGB non-performance or failure to perform in accordance with contract gives right to an aggrieved party to terminate on notice, unless the breach was immaterial or the non-defaulting party drastically contributed to non-performance. Furthermore, according to Sec. 323(4) BGB an aggrieved party may terminate a contract before performance becomes due if it is obvious that the preconditions for termination will be satisfied, which is similar to the doctrine of anticipatory breach.

Under Sec. 349 BGB, termination is effected by declaration to a breaching party. A party wishing to terminate the Contract, should give the defaulting party a notice of termination, which should also generally provide for additional, reasonable time for the party to remedy the breach, failing which the termination takes effect. This additional time

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<sup>82</sup> MUSGRAVE, *ibid*, p. 348.

<sup>83</sup> Reinhard ZIMMERMANN, *Breach of Contract and Remedies under the New German Law of Obligations*, 2002, p.15, D.A, 13.2.2019, <http://www.cisg.law.pace.edu/cisg/biblio/zimmerman.html>

<sup>84</sup> Werner LORENZ, "Reform of the German Law of Breach of Contract", *Edinburgh Law Review*, Vol. 1, Iss. 3, 1997, p.p. 317 – 344, p. 325.

may be excluded in certain cases (implicit or explicit refusal to perform, inconvenience of notice, fixed date of performance, etc.).

When termination occurs, both parties are released from their duties to perform in perspective. Effects of termination are laid down in Sec. 346 BGB, which summarily provides that any performance received shall be returned along with benefits derived from such performance, and any unjust enrichment must be returned.

In addition to that the non-defaulting party may demand compensation for the loss suffered due to the breach of duty as under Sec. 347(2) BGB, and this party's right to claim compensation together with termination right has also been preserved by Sec. 325 by stating that the termination of bilateral contract does not preclude right to claim compensation.

In short, German law only allows termination in case of non performance of a main obligation and/or after a so-called grace period was given to the debtor within which it could still perform but did not<sup>85</sup>.

## **B. Termination in Common Law**

Under Common law, termination may occur under two events: 1) due to default or 2) for convenience (provided by the contract only).

Termination by default is very simply one that occurs because there has been a breach of the terms of contract. As such, with regard to this termination by default, Common law has come up with certain criteria that ought to be met before this relief is allowed, and this is in order to prevent it from being abused or used lightheartedly and more so to protect the sanctity of contracts.

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<sup>85</sup> SMITS, *ibid.*, p. 69.

The right to terminate due to a default will arise in three circumstances:(1) a breach of an essential term; (2) a sufficiently serious breach of a non-essential term; or (3) the repudiation or renunciation of the contract by the other party<sup>86</sup>.

### **1. Breach of an essential term**

Essential terms are also described as “conditions” or “fundamental” terms, which is distinct from “warranties”.

The test of whether a term is an essential term depends on whether it was the common intention of the parties, expressed in the language of their contract, that the term be so “essential” that any breach of it would justify termination. A well accepted example of an essential term is where time is expressed to be of the essence in that contract.

### **2. Sufficiently serious breach of a non-essential term**

Breaches of non-essential terms, if sufficiently serious, may also give rise to a right to terminate a contract at common law. Non-essential terms, include for example warranties.

The Old Sale of Goods Act (1893, UK) made a distinction between warranties and conditions, and this was transferred into the current English SGA (1979). While conditions are terms, obligations, and provisions imposed by the buyer and seller while entering into a contract of sale, which need to be satisfied, warranties on the other hands, i.e. Nonessential terms, are a guarantee given by the seller to the buyer about the quality, fitness and performance of the product<sup>87</sup>.

In this context, non-essential terms are also referred to as “intermediate” or “innominate” terms and normally, if the warranty that was given proves false, and the product does not function as described, then reliefs such as exchange of the faulty item, are

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<sup>86</sup> Fred PRICKETT, *Terminating contracts*, May 2013, D.A 12.4.2019,

<https://www.claytonutz.com/knowledge/2013/may/terminating-contracts>

<sup>87</sup> S.SURBHI, *Difference Between Condition and Warranty*, July 2015, D.A 12.4.2019,

<https://keydifferences.com/difference-between-condition-and-warranty.html>

available to the buyer. However, if there is a sufficiently serious breach of this non-essential term then termination is allowed. A sufficiently serious breach is described as a breach “going to the root of the contract” or a breach, in which the non-breaching party is significantly deprived of the benefit that was the purpose of the contract<sup>88</sup>.

The decision of the High Court in the face common law case known as *Koompahtoo* affords a good example. In that case, the Koompahtoo, which is a local Aboriginal land council (land council) entered into a joint venture with a property developer, Sanpine Pty Ltd (Sanpine), for the development of a large area of land. The land council contributed the land and the obligation of Sanpine was to manage the development. Sanpine, in discharging its duties caused liabilities of \$2 million to be incurred, secured by mortgages over the land and the land was nevertheless not developed. The mortgagee went into possession of the land and the land council was placed into administration. The central issue was whether the administrator of the land council was entitled to terminate the joint venture agreement on the basis that Sanpine had breached its obligation to maintain books of account and financial records of the joint venture<sup>89</sup>.

The majority of the High Court were satisfied that, although not contained in the agreement, the obligation they failed to do was of paramount importance so as to constitute an essential obligation justifying breach. Further a majority of the judges stated that, even if it were accepted that all of the contractual obligations which Sanpine breached were not essential obligations justifying termination for breach, the breaches “were in a number of respects gross, and their consequences were serious”. The failure of Sanpine to explain the use of all of the funds borrowed against the land and to otherwise maintain proper books of account and financial records of the joint venture “went to the root of the contract” and deprived the land council of “a substantial part of the benefit for which it contracted”, so as to justify termination.

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<sup>88</sup> MUSGRAVE, *ibid*, p. 342.

<sup>89</sup> Julie CLARKE, *Australian contract law*, D.A 16.3.2019  
<https://www.australiancontractlaw.com/cases/koompahtoo.html>

### 3. Repudiation

Repudiation extends beyond actual breaches of essential terms and sufficiently serious breaches of nonessential terms justifying termination, to embrace situations that occur before performance of obligations under the contract, which are known as anticipatory breaches. Anticipatory breaches are conducts which evidence “an unwillingness or an inability to render substantial performance of the contract” or “an intention no longer to be bound by the contract or to fulfil it only in a manner substantially inconsistent with the party’s obligations”<sup>90</sup>.

With regard to termination by convenience, common law generally allows parties to a contract to agree that either of them may at any time have the right to call for termination of the contract without any reason. This principle is for instance, reflected in Sec. 2-106 (3) UCC.

According to the UCC either party has a right by virtue of contract to put an end to the contract without its breach; as result all obligations for the future cease while the rights, based on prior breach of performance, survives.

Further, it is important to note that the rules regulating the sanction of termination are much more relaxed under common law than the civil law, for instance in England, the injured party who wishes to terminate needs only to communicate to the defaulting party – orally or in writing – that he is treating the contract as at an end. Unlike France, such party does not have to give any reason, as long as a valid reason exists he is entitled to terminate, nor is he is under obligation to give notice or additional period to the defaulting party to remedy the breach. Termination takes effect immediately.

Unlike in civil law, the sanction for wrongful termination under common law, is not to compel performance but damages. The court does not have a general power to grant a period of grace and the defaulting party is also unable to invoke the principle of good faith

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<sup>90</sup> MUSGRAVE, *ibid*, p. 343.



to challenge termination. This is justified by a desire for commercial certainty and the speedy resolution of disputes<sup>91</sup>.

### **C. Termination in International Unification Sources**

Various instruments of international unification also provide for and recognise the sanction of termination.

Art. 9:301 PECL entitles the aggrieved party to terminate the contract if non-performance of the other party is fundamental or in the case of delay in performance of a non-fundamental obligation, the aggrieved party after giving a notice fixing an additional period of time of reasonable length, it may terminate the contract at the end of the period of notice, if the failure persists.

Art. 9:304 PECL also allows a party to terminate a contract even prior to when performance falls due if it is clear that there will be a fundamental non performance (anticipatory non-performance).

A breach is considered fundamental if (i) it substantially deprives non-breaching party of expected result (unless the breaching party has not foreseen and could not reasonably foresee such result), (ii) strict compliance with the obligation is of the essence of the contract; or (iii) the non-performance is intentional and gives the aggrieved party reason to believe that it cannot rely on the other party's future performance.

Pursuant to Art. 9:303 PECL an aggrieved party's right to terminate a contract is to be exercised by notice, and in the event the aggrieved party keeps silent for a reasonable time after becoming aware of the breach, this party loses its right to later seek termination.

Pursuant to Art. 8:106 PECL, in the notice that is sent following a default, a party may fix an additional time for the defaulting party to remedy the breach and in the event of

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<sup>91</sup> Guido CALABRES, *Private Law Beyond the National Systems*, British Institute of International and Comparative Law Publishers, London, 2007, p. 1083.

expiration of such time, without the party performing remedying the breach then the contract is terminated.

It should be noted though, that through Art. 8:108 PECL, a breaching party's non-performance is excused if it proves that it is due to an impediment beyond its control and that it could not reasonably have been expected to take the impediment into account at the time of conclusion of the contract, or to have avoided or overcome the impediment or its consequences. However, the breaching party is under duty to ensure that he communicates these circumstances to the other party within reasonable time.

Effects of termination as provided by Art. 9:305 PECL, are as follows: 1) parties are released from future performance and obligation, but rights and liabilities accrued prior to termination remain unaffected; 2) provisions on settlement of disputes and those intended to terminate after termination remain unaffected (for instance, confidentiality obligations).

Additionally, under the PECL, the terminating party may reject any property being given, if its value reduced due to non-performance. Also upon termination, aggrieved party may recover money paid for non-received or properly rejected performance. At the same time, a party who supplied property, which can be returned, may recover it, if it was not paid or other counter-performance was not received (Art. 9:308 PECL). If on the other hand, rendered performance cannot be returned and was not paid or compensated by counter-performance then reasonable value of it can be recovered upon termination (9:309 PECL).

In accordance with DCFR, in particular Art. 1:108, a contract can be terminated at any time, provided it has been agreed as such by the contract, or in case of breach, including anticipated breach as is captured under Art. 3:504 of the DCFR.

Similarly to PECL, the DCFR provides that termination is effected by notice within reasonable time, a late notice invalidates right to terminate as stated under Art. 3:508 DCFR. While the DCFR provides that a party ought to give the defaulting party time to remedy his default, this additional period for cure may not be served in case where the

breach is fundamental, intentional or anticipated, or cure would be inappropriate in the circumstances as under Art. 3:203 DCFR.

Definition of fundamental breach is similar to the one in PECL (III, Art. 3:502 DCFR). i.e., If the breach (whether whole or in part) substantially deprives the creditor of what the creditor was entitled to expect under the contract, unless at the time of conclusion of the contract the debtor did not foresee and could not reasonably be expected to have foreseen that result; or it is intentional or reckless and gives the creditor reason to believe that the debtor's future performance cannot be relied on.

Under the DCFR, effects of termination are regulated by Art. 3:509 and are similar to those provided for by PECL, and of importance is termination does not preclude claim for damages.

Also, DCFR sets forth notion of restitution in respect of benefits received by performance. Art. 3:510 DCFR states that a party who has received benefits from performance should return them; money paid should be returned, any property acquire should be returned, and if impossible (in case transfer would cause unreasonable effort or expense) then this item can be substituted by its value (measured at the time of performance). Art. 3:512 and Art. 3:514 also state that reduction in value should be compensated, as well as improvement and usage should be reasonably reimbursed (Art. 3:513 DCFR).

Art. 49 (1) of the CISG talks about termination and grounds for avoidance, it stipulates that a buyer may declare the contract avoided in case the failure by a seller constitutes a fundamental breach, or in relation to non-delivery – where a seller do not deliver within additionally fixed period or declares unwillingness to deliver within that period.

In cases where the goods have been delivered, a buyer loses right to avoid the contract unless she declares the same within reasonable time after she becomes aware of the late delivery or in respect of other breaches a party ought to declare termination within

reasonable time from the moment the breach is known or should be known (Art. 49 (2) CISG).

Previously, under the CISG, a contract could be considered automatically terminated in the event of the breach, without need of a notice. However, this ‘automatic or *ipso facto*’ avoidance was deleted from the CISG, because it led to uncertainty as to whether the contract was still in force or whether it has been *ipso facto* avoided.’ Accordingly, in order to bring certainty and help the situation, Article 26 was introduced and is viewed as making ‘one of the significant advances of the CISG over the years.’<sup>92</sup>

Art. 26 of CISG, similar to the principles that are embodied under the other unification sources, states that the buyer must declare the contract avoided by means of a notice to the seller, in other words, the termination of the contract is effective only if made by notice to the other party. Since the right of avoidance ‘is made dependent on a declaration’ this means that ‘the entitled party can consciously decide to continue to claim performance of the contract, even when there are grounds for termination’<sup>93</sup>.

#### **D. Intermediate Conclusions**

The sanction of termination essentially puts an end to contractual obligations and has the effect of parties being released to their obligations and being restored to their positions before the contract, as such, contract law in order to preserve the sanctity of contract, treats this sanction very delicately.

The different legal systems have adopted different ways to deal with this remedy, take for example; in common law there is no obligation for a party to give notice, as well as additional time to the defaulting party in order to rectify the breach. In most civil law countries however, an injured party must give notice to the other and allow him reasonable time to remedy the same.

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<sup>92</sup> John O. HONNOLD, *Uniform Law for International Sale under the 1980 United Nations Convention, Hague*, 1999, Kluwer Law International Publishers, 3<sup>rd</sup> Ed., p. 283.

<sup>93</sup> Fritz ENDERLEIN and Dietrich MASKOW, *International Sales Law*, 1992, New York, Oceana Publications, p. 117.

Civil law seems to take a more guarded approach to this sanction, in fact, as above mentioned, the sanction of termination rarely existed at the start of civil law, and when it began, only courts were allowed give this sanction, and parties could not by themselves terminate an agreement. In fact, even in recent times, the principle of good faith during performance and even at termination stage is given much more importance in civil law countries. In contrast there is no general duty in common law to perform a contract with good faith<sup>94</sup>.

Analysis shows that court both in Civil and Common law jurisdictions plays similarly significant role in permitting termination with damages' compensation and/or preserving the agreement and awarding specific performance, whenever it deems just.

This remedy is nonetheless highly criticized for economic inefficiency, moral hazard and risk of terminating party opportunism. Take for instance, If the bell is missing on the bicycle that Omer buys from Sezgin, this does not usually justify termination because the breach is not serious enough (although it would be possible for Omer to claim performance of the contract or damages). As such, its application should be restricted to cases of fundamental breach, limited judicial supervision seems reasonable to prevent misuse, and that is why most legal systems will only allow termination in respect of breaches that are sufficiently serious. In fact, the best solution would be for parties in exercising their rights of contractual freedom, they should regulate this right in the negotiated contract.

#### **IV. THE SANCTION OF PRICE REDUCTION**

Price reduction, naturally a unilateral right of the aggrieved buyer to whom non-conforming goods have been delivered or any such breach that can be excused. The

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<sup>94</sup> SOLENE, *ibid*, p. 8.

consequence of use of this remedy is a reduced payment obligation to the non-defaulting party<sup>95</sup>.

## A. Price Reduction in Civil Law

The sanction of price reduction is a traditional civil law sanction that is derived from *actio quanti minoris* in Roman law<sup>96</sup>. The Roman law remedy of *actio quanti minoris* allowed a purchaser in a contract to bring forth an action against the seller to reduce the purchase price payable when the seller delivered defective goods.

This sanction is acknowledged in several in international and EU legislation and model regulations and has even been embodied in the German Civil Code.

Germany has kept the remedy of a price reduction as applicable in specific cases. Under section 439 of the BGB, where the seller supplies defective goods, the buyer has a statutory right to request the repair or replacement of the defective goods. If the seller does not fulfil its obligation to repair or replace the defective goods, the buyer can either under section 440 of the BGB rescind the contract and claim reimbursement of the purchase price or as stated in section 441 of the BGB demand a reduction of the purchase price.

It is important to note that this remedy generally only becomes applicable, where the injured party has first set a reasonable deadline for the seller to cure the defect and this deadline expires without the defect being cured<sup>97</sup>.

Also, Section 441 goes on to state that, in the case of a price reduction, the purchase price is to be reduced in the proportion in which the value of the thing free of defects would, at the time when the contract was entered into, have had to the actual value. To the extent necessary, the price reduction is to be established by appraisal, which is a formal

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<sup>95</sup> Reza BEHESHTI, "Price Reduction Versus Damages: A Battle Without a Winner", *Uniform Law Review*, Vol. 21, Iss. 2-3, pp. 216-233, p. 220.

<sup>96</sup> Eric E. BERGSTEN & Anthony J. MILLER, "The Remedy of Reduction of Price", *The American Journal of Comparative Law*, Vol. 27, Iss. 2-3, 1979, pp. 255-277, p 245.

<sup>97</sup> Angus Charles JOHNSTON, Et.al, *The German Law of Contract: A Comparative Treatise*, 2006, 2<sup>nd</sup> Ed., p 514.

assessment done by an expert in the field. In the event the buyer has paid more than the reduced purchase price, the excess amount is to be reimbursed by the defaulting party.

It is important to note that this right of a buyer only becomes available if the buyer had no knowledge of the defect at the time of contracting. Section 442 states that the rights of the buyer due to a defect are excluded if he has knowledge of the defect at the time when the contract is entered into.

France has also introduced a general rule of price reduction in all cases of non performance. Under Art. 1217. –A party towards whom an undertaking has not been performed or has been performed imperfectly, may among other remedies request a reduction in price.

Article 1223 of the FCC goes on to state that having given notice to perform, a creditor may accept an imperfect contractual performance and reduce the price proportionally, and if he has not yet paid, the creditor must give notice of his decision to reduce the price as quickly as possible.

In Turkey, under Article 227 of the Turkish Code of Obligations, if the seller fails to perform his/her obligations, the buyer can ask for, among other remedies, the sanction of price reduction<sup>98</sup>.

The TCO also provides for the reduction of price as a type of sanction available for the buyer of defective goods. It is noteworthy to mention that in Turkey, the TCO only empowers the court to determine the difference in value between the contract price and the actual value. Secondly, Article 202(2) of the TCO gives the judge the discretion to order the reduction of price, even though the intention of the buyer is not so.

In the case of an action for rescission, if the circumstances do not justify the termination, it is at the discretion of the judge to grant the price reduction instead of the rescission of the contract. Consequently, under Turkish law, there are two types of price

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<sup>98</sup> M Fevzi TOKSOY, Kenan Güler ACTECON, *Sale and storage of goods in Turkey: Overview*, [https://uk.practicallaw.thomsonreuters.com/1-619-8990?transitionType=Default&contextData=\(sc.Default\)](https://uk.practicallaw.thomsonreuters.com/1-619-8990?transitionType=Default&contextData=(sc.Default))

reduction remedy, namely, voluntary and compulsory price reduction, while in several other jurisdictions, that remedy has a voluntary character, i.e., it is at the discretion of the buyer to elect or not to elect that remedy<sup>99</sup>.

Turkish law, with respect to the calculation of the amount to reduce, adopt the same method as most of the other jurisdictions, namely the proportional method: the buyer is entitled to claim a price reduction in the same proportion as the value of non-conforming goods has to conforming goods at the delivery date<sup>100</sup>.

## **B. Price Reduction in Common Law**

Historically the remedy of price reduction is alien or rather foreign to common law<sup>101</sup>. It has been submitted severally before that ‘common law systems do not recognize the principle of price reduction for defects in goods’. Likewise, it has been expressed severally that common law lawyers have in the past had great difficulty in understanding the nature of the remedy of price reduction and tended to confuse it with the remedy of damages<sup>102</sup>.

Nonetheless, English law has recently tried to incorporate and utilize this sanction. A general remedy of price reduction can be found in Section 30 of SGA. This section states that, where the seller delivers to the buyer a quantity of goods less than he contracted to sell, the buyer may reject them, but if the buyer accepts the goods so delivered he must pay for them at the contract rate.”

Consequently, under English law, if the seller has delivered less than the contracted quantity of goods and the buyer accepts the goods, the buyer must "pay for them at the

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<sup>99</sup> Yavuz, C., Yavuz, *Saticinin Malin Ayiplarindan Sorumlulugu, [Liability of the Seller for Defective Goods]*, Istanbul, 1989 at p. 148

<sup>100</sup> Cagdas Evrim ERGUN, *Comparative Study on the Buyer's Remedies Under the 1980 Vienna Sales Convention and Turkish Sales Law*, 2002, <http://www.cisg.law.pace.edu/cisg/biblio/ergun.html>

<sup>101</sup> Nils JANSEN, Reinhard ZIMMERMANN, *Commentaries on European Contract Laws*, Oxford University Press, 2018, p 1425.

<sup>102</sup> Chengwei LIU, ‘*Price Reduction for Non-Conformity: Perspectives from the CISG, UNIDROIT Principles, PECL and Case Law*’, 2005, D.A 13.5.2019, <http://www.cisg.law.pace.edu/cisg/biblio/chengwei1.html>



contract rate." The reference to "contract rate" is comparable to the "proportional" calculations made under Article 50 of the CISG, or even other civil law jurisdictions that apply the same principle.

Section 53 of SGA also contemplates a similar concept, though it applies only to breaches of warranty and is phrased in terms of setting off the breach against the price due<sup>103</sup>. In case of breach of warranty of quality of goods, such loss is prima facie the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had fulfilled the warranty. However, under this section, there is no general right on the part of the buyer to reduce the price unless set up as a defense to the seller's action for the price.

### **C. Price Reduction in International Unification Sources**

Article 50 of the CISG provides for the sanction of price reduction for the buyer. This article applies when the delivered goods do not conform to the contract. This remedy is applicable 'whether the non-conformity constitutes a fundamental or a simple breach of contract and also whether or not the seller acted negligently. It is also applicable regardless of whether seller was exempted from liability under Article 79<sup>104</sup>.

For sake of completeness, Article 79 deals with the failure of a party to perform his obligation due to an impediment beyond his control or one that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract as well as a party's failure to fulfill his obligations under contract due to the failure by a third person whom he has engaged to perform the whole or a part of the contract. The CISG is clear that even in such circumstances, the sanction of price reduction is applicable.

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<sup>103</sup> Peter A. PĪLIOUNĪS, "The Remedies of Specific Performance, Price Reduction and Additional Time (Nachfrist) Under the CISG: Are These Worthwhile Changes or Additions to English Sales Law?", *Pace Int'l L. Rev.*, Vol.12, Iss. 1, 2000, pp. 1-46, p. 32.

<sup>104</sup> S. KROLL, L. MĪSTELĪS & P.P. VĪSCASĪLLAS, *UN Convention on Contracts for the International Sale of Goods (CISG) Commentary*, Hart Publishing, 2011, p. 752.

Article 50 of the CISG has originated from *actio quanti minoris* of the Roman law<sup>105</sup>. Which simply means that in the event a buyer becomes aware, after delivery, of certain specified defects which the vendor did not declare and which, had the buyer been aware of them at the time of sale would have led him to pay a lesser price, he can bring an action for reduction of price or for termination of contract<sup>106</sup>.

However, the remedy of price reduction has limited application: it cannot be used for breaches consisting of late delivery and non-delivery, as the price is reduced on the basis of delivered non-conforming goods being either defective in quality or quantity. Price reduction only covers ‘both delivery of non-conforming goods and delivery of an aliud’ (totally different goods).

Also, the application of price reduction is generally restricted by placing a duty on the buyer to notify the seller of the defects in the goods delivered. In other words, the buyer needs to initially give timely notice of the non-conformity to the seller, before declaring a price reduction. If he does not perform his notification duty, he might be debarred from his right of price reduction as is stipulated under Article 39 of the CISG<sup>107</sup>.

CISG, under Article 50, provides the buyer with the right to ‘unilaterally alter the terms of the contract’. The buyer does not need to have recourse to the court in order to exercise this right, which gives him very valuable procedural strategic advantages. The buyer can apply this remedy by timely declaration, as this article only requires the buyer to declare a reduction of the purchase price<sup>108</sup>.

The content of declaration must very clearly and categorically state that the buyer wishes to reduce the purchase price but it need not necessarily include the technical term of “price reduction”. Article 50 of the CISG specifically explains price reduction as a

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<sup>105</sup> Reinhard ZIMMERMANN, “The Law of Obligations, Roman Foundations of Civilian Tradition”, *Duke Journal Of Comparative & International Law*, 1992, Vol.2, Iss. 2, pp. 310-322, p. 318

<sup>106</sup> BERGSTEN and MILLER, *ibid*, p. 256.

<sup>107</sup> Kroll, Mistelis and Perales VISCASILLAS, *UN Convention on Contracts for the International Sale of Goods (CISG)*, 2<sup>nd</sup> Ed., 2018, p. 752.

<sup>108</sup> BEHESHTI, *ibid*, p.222.

unilateral action of the buyer. In other words, the buyer can assert this right with no need to wait for the seller to start any legal action.

According to Sec. III-3:601 of the DCFR a party accepting non-conforming delivery may reduce the price proportionally to the decrease in the value of the performance at the time of performance, or, if price is paid, may recover the excess from the other party. Use of this remedy precludes recovery of damages for reduction in the value of the performance (but preserves entitlement to damages for any further loss).

Art. 9:401 PECL stipulates rules identical to DCFR. Also, price reduction under CISG, DCFR and PECL does not require expert appraisal and available even when non-performance is excused<sup>109</sup>.

There has also been argument on whether it should be asserted whether price reduction is a claim or a defence<sup>110</sup>. The significance of this argument comes to the fore especially where if price reduction is viewed to be a defence in nature and the parties have waived their defence rights. In this particular scenario, the buyer is barred from asserting a price reduction, even though the necessary requirements are satisfied for pursuing a reduction of price, such as the existence of non-conformity and the giving of timely notice of the non-conformity.

Accordingly, while several people say that it should only be used as a defence, this idea of recognising price reduction as a defence has not been widely accepted<sup>111</sup>. CISG Article 50 specifically explains price reduction as a unilateral action of the buyer. In other words, the buyer can assert this right with no need to wait for the seller to start any legal action<sup>112</sup>. Thus, price reduction should be considered a claim, and not a defence.

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<sup>109</sup> European COMMISSION, *Justice and Fundamental Rights*, D.A 3.5.2019  
[https://ec.europa.eu/info/policies/justice-and-fundamental-rights\\_en](https://ec.europa.eu/info/policies/justice-and-fundamental-rights_en)

<sup>110</sup> European COMMISSION, *Ibid*.

<sup>111</sup> Arnau Muriá TUNON, *The Actio Quanti Minoris and Sales of Goods Between Mexico and the U.S.: An Analysis of the Remedy of Reduction of the Price in the UN Sales Convention, CISG Article 50 and its Civil Law Antecedents*, 1998, <https://www.cisg.law.pace.edu/cisg/biblio/muria.html>

<sup>112</sup> LIU, *ibid*.

## **D. Intermediate Conclusions**

This Roman law remedy, which provides monetary relief to buyers who have received non-conforming goods, is reflected in contemporary civil law codes as well as other sources of law. The overall function of the remedy is to preserve the bargain and "to allow the buyer to keep the defective goods and pay the price it otherwise would have paid had it been aware of the hidden defects in the goods.

The sanction of price reduction is an alternative relief to the claim for damages, especially in those circumstances where payment has not been effected<sup>113</sup>. Unlike damage-based sanctions, the principle of the price reduction relief is not dependent on actual loss being suffered by the buyer, but is solely dependent on the abstract relationship between the actual value of the goods delivered and the hypothetical value of goods conforming to the contract.

The aim of this sanction is to preserve the contract and ensure justice prevails. The innocent party of the contract is able to keep the defective goods/service and reduce the purchase price of the contract to the amount it otherwise would have paid had it been aware of the hidden defects in the goods or service to be delivered.

Unlike damages, this remedy is not designed to protect 's expectation, reliance, or restitution interests. Price reduction can thus be characterised to be neither damages nor partial avoidance of the contract, but rather an adjustment of the contract. Price reduction is unique in this regard.

Finally, it is important to note that in applying this sanction, all jurisdictions discussed above, base their calculations on the "proportionate" principle, which is by making computations on the simple basis of comparison of the actual value of the goods delivered and the standard value of goods conforming to the . This type of calculation is called 'proportionate'.

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<sup>113</sup> BERGSTEN & MÖLLER, *ibid*, 267.

## V. THE SANCTION OF WITHHOLDING PERFORMANCE

Withholding performance is one of the sanctions that is applicable in the event where there is a breach of contract. It takes the form of an option available to the innocent party in a contract, to, in good faith, temporarily suspend performing his part of contractual obligations in a mutually binding contract, until the defaulting party intends to fulfill his part of obligations, and where that is not done, this innocent party may proceed to terminate the contract.

### A. Withholding Performance in Civil Law

In all civil law jurisdictions, suspension of performance is governed by the *exceptio non a dimpleti contractus*. *Exceptio non a dimpleti contractus*, is a Latin term which means “an exception in a case with regard to a contract involving mutual duties or obligations, to the effect that the plaintiff may not sue the other, if the plaintiff has not performed his own part of the obligations in that contract”. This exception or defense has its roots in Roman law, and it essentially means that a person who is being sued for non-performance of contractual obligations can defend themselves by proving that the plaintiff did not perform their side of the bargain<sup>114</sup>.

This principle is found in the laws of almost every civil law jurisdiction, either explicitly named (i.e. in the Germanic systems) or impliedly (in the Franco-Roman systems)<sup>115</sup>.

This principle which is a defence and/or exception of unperformed contract, essentially provides for the right of withholding/suspending own performance in a contract with reciprocal obligation as well as the right to any other sanctions such as specific performance and termination.

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<sup>114</sup> Duhaime's Law DICTIONARY, *Exceptio Non Adimpleti Contractus Definition*, D.A.30.4.2019, <http://www.duhaime.org/LegalDictionary/E/ExceptioNonAdimpletiContractus.aspx>

<sup>115</sup> Reinhard ZIMMERMAN, *The Law of Obligations: Roman Foundations of the Civilian Tradition*, Oxford Univeristy Press, Oxford, 1996, p. 801.

An essential feature of this sanction of withholding performance, is that it does not require the non-performance to be fundamental and neither does it call for the court intervention, as such it can be termed as a self-help remedy or measure of private justice<sup>116</sup>.

However, it should be noted that civil law countries influenced by this principle and adopting the sanction of withholding performance, have laid down guidelines on how it should be applied. In France for instance, the severity of the breach is an important factor; the breach must be significantly serious. Under the FCC, the effect of the breach on the injured party is key; one common formulation is that the breach must be such that, “if the aggrieved party had known of it, he would not have entered into the contract”. Opinion is divided on some specifics, but French commentators agree on the whole that the exceptio should only be available in cases of severe breaches<sup>117</sup>.

Pursuant to Art. 1612, 1613, 1653, 1707 1804 FCC( which has been in use until recently) an innocent party in a concurrent obligation, is entitled to withhold performance (delivery/payment) when the counterparty has not performed as required under the terms of the contract or there is substantial risk of this other being unable to perform his part of the obligations based on the proportionality/reasonability test.

The sanction is of temporary and provisional nature and withholding party should be ready to perform immediately upon other party’s performance or sufficient assurance of the respective performance.

In Germany, this remedy of withholding performance is characterised by clarity and simplicity. It is expressed in BGB section 320, entitled Enrede des nicht erfüllten Vertrags (“defence of failure to perform the contract”), which states:

*“(1) Unless the contract requires him to perform first, a person bound by a synallagmatic contract may refuse to perform his part until the other party effects counter-performance....*

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<sup>116</sup> Mark P. GERGEN, “A Theory of Self-Help Remedies in Contract”, *Boston University Law Review*, 2009, Vol. 89, p.p. 1431 – 1435, p. 1433

<sup>117</sup> GERGEN, *Ibid*, p.1433.

*(2) If one party has partially performed, counter-performance may not be refused if, under the circumstances, in particular on account of the relative insignificance of the part not performed, the refusal would constitute bad faith”.*

BGB section 320(1) restricts the application of the exceptio to true synallagmatic contracts, i.e., those where each party’s promised performance is exchanged for the other’s<sup>118</sup>.

Moreover, German law also assumes, absent contrary intent of the parties, that performance in a synallagmatic contract is simultaneous<sup>119</sup>. If the contract specifies a particular order of performance or if the contract belongs to a class of nominate contracts in which sequential performance is the rule, then the party who performs first may not suspend its performance under section 320.

In other words, section 320 of the BGB states that a person who is a party to a reciprocal contract may refuse his part of the performance until the other party renders consideration subject, unless he is obliged to perform in advance. If performance is to be made to more than one person, an individual person may be refused the part performance due to him until the complete consideration has been rendered.

Also, under the German laws, refusal to perform is only warranted when termination would have been warranted, this essentially means the standard of seriousness of breach is equivalent to the one needed in the sanction of termination. In other words, the German rule requires merely that the breach be “not trivial”, and it is to the effect that the availability of the sanction of suspension of performance is limited to cases of material breach<sup>120</sup>.

German law also requires courts to pay close attention to the innocent party’s conduct. BGB section 320(2) provides that the innocent party may not suspend

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<sup>118</sup> Guenter Heinz TREITEL, “Specific Performance in the Sale of Goods”, *Journal of Business Law*, 1966, Vol. 211, p. p. 223 – 310, p.249.

<sup>119</sup> *Ibid*, p. 287

<sup>120</sup> *Ibid*, p. 304

performance if doing so would constitute bad faith. This has evolved through case law into a rule of proportionality: if the performance suspended by the creditor is substantially greater than the breach committed by the debtor, courts may give effect to the exceptio only to the extent of the debtor's breach. German law, therefore, focuses on whether the creditor's suspension of performance was proportionate; the extent of the breach is relevant to this determination but is not decisive<sup>121</sup>.

Section 321 BGB additionally secures the availability of this sanction in case of anticipatory breach. It stipulates that a person who is obliged to perform in advance under a reciprocal contract may refuse to render his performance if, after the contract is entered into, it becomes apparent that his entitlement and/or obligations due to him are jeopardised by the inability to perform of the other party. It goes without saying that the right to refuse performance is not applicable if consideration is rendered or security is given for it<sup>122</sup>.

Moreover, German law states that the person required to perform in advance may specify a reasonable period in which the other party must, at his choice, render consideration or provide security reciprocally and simultaneously against performance. If the period ends without result, the person required to perform in advance may revoke the contract.

In short, German seems to restrict the remedy of withholding performance to cases of true synallagmatic contracts, which means that this remedy of suspension of performance is available in a smaller range of contractual disputes than in other countries<sup>123</sup>.

## **B. Withholding Performance in Common Law**

In Common law there is no general equivalent to the Civil law remedy of withholding performance.

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<sup>121</sup> TREITEL, *ibid*, p. 303

<sup>122</sup> Reinhard Zimmermann, *Breach of Contract and Remedies under the New German Law of Obligations*, 2002, Roma, p.p. 18 - 19 .

<sup>123</sup> TREITEL, *ibid*, p. 304



While Civil law jurisdictions, as discussed above, recognize some version of the *exceptio non adimpleti contractus*, which grants injured parties the right to suspend performance without terminating the contract. Common law does not permit injured parties to withhold performance without discharging both parties' unperformed obligations. In other words, the injured party cannot exert pressure on the breaching party to perform its obligations by temporarily withholding its own performance<sup>124</sup>.

This leaves the injured party in a Common law jurisdiction in a very delicate position: if it performs its remaining obligations, it must then sue for damages, which is a lengthy, expensive, and uncertain route. If, on the other hand, it withholds performance, it risks being held to have repudiated the contract.

The distinction between the two systems, Common law and Civil law, originates from the earlier mentioned division in Common law, of the terms of a contract into conditions and warranties. This division provides for comparatively wide independence of the parties' obligations from each other (unless the contract explicitly makes a particular obligation as a condition precedent), and most importantly, the Common law separation of the breach into material (where term is classified as a condition/ fundamental intermediate term) and less significant breach (where the term is classified as a warranty) provides for the generally available repudiation of contract without recourse to the court in the former case and claim for damages - in the latter. On the hand, Civil law doctrine ensures interdependence of the obligations of both parties, so default of one temporarily excuses the other, as a consequence of default.

Under the Common law, if one party failed to perform, the other had no choice but to perform and later sue for damages. Withholding any performance carries with it legal consequences. A party withholding performance will be held to have repudiated the

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<sup>124</sup> Joshua KARTON, "Recognizing a Contractual Right to Suspend Performance", *Queen's University Legal Research Paper No. 2015-018*, 2014, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2489048](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2489048)

contract, and if the debtor's breach is eventually determined not to have been material, the innocent party may find itself on the losing end of a breach of contract suit<sup>125</sup>.

However, specific doctrines already exist in Common law jurisdictions that grant injured parties the right to suspend their performance in certain narrow circumstances or provide some of the advantages of suspension<sup>126</sup>.

Take for instance, Sec. 28 of English SGA (default provision), which states that delivery of the goods and payment of the price are concurrent obligations. Accordingly, and pursuant to Sec. 41 of English SGA, an unpaid seller is entitled to retain possession of goods (right of lien or retention).

The Irish Sale of Goods Act 1893, s.28 is to the same effect as well; that unless otherwise agreed, delivery of goods and payment of the price are concurrent conditions, that is to say, the seller must be ready and willing to give possession of the goods to the buyer in exchange for the price and the buyer must be ready and willing to pay the price in exchange for possession of the goods, failure to which, a right to lien (which we may take to be a form of withholding performance) may be effected.

When it comes to a contract where performance is recipricol, Common law generally applies the same test for termination in withholding performance, which is, a party may only withhold his performance because the other has not performed if: (a) the party's obligation to perform is expressly or by implication made dependant on the performance by the second party, or (b) the court defines the second party's obligation as being a condition of the contract, or (c) the second party's non-performance would deprive first party from the benefit contracted for<sup>127</sup>.

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<sup>125</sup> E Allan FARNSWORTH, *Contracts*, 3<sup>rd</sup> Ed., 1999, Aspen Law and Business Publishers, New York, p. 553-554.

<sup>126</sup> Mark P. GERGEN, "A Theory of Self-Help Remedies in Contract", *Boston University Law Review*, 2009, Vol. 89, p.p. 1397 – 1449, p. 1409.

<sup>127</sup> William J. GELLER, "The Problem of Withholding in Response to Breach: A Proposal to Minimize Risk in Continuing Contracts", *Fordham Law Review*, 1993, Vol. 62, p.p. 163 – 204, p. 165.

In Scottish law, the principle of mutuality of contract enables a party to withhold performance in response to the other party's breach, so long as there is a link between the breach and the performance withheld: *Bank of East Asia v. Scottish Enterprise*, 18 January 1996 (H.L.) (unrep.)<sup>128</sup>.

Alternatively, where there is a breach of contract, the aggrieved party may initiate action for the price and damages. English law also seem to be more safeguarding interests of the innocent party, allowing her to complete own performance and then recover contract price, unless she has no legitimate interest in performance<sup>129</sup>.

As with English law, US law does not expressly distinguish between different levels of breach to justify suspension and termination<sup>130</sup>. §2-717 UCC adopts a liberal standard regarding sales' contracts, allowing a buyer of goods deduct damages from the price as a result of the seller's breach, this has developed in turn as a standard of justified withholding of performing your full obligation, when it is commercially reasonable. Withholding is subject to the sufficient notice and can be applicable only regarding damages for breach under the same exact contract<sup>131</sup>.

There is however dissonance in court practice in USA, mainly due to lack of consistent legislative regulating withholding terms, which are usually incorporated in the contract<sup>132</sup>. Nevertheless certain areas of American law provide for specialized withholding rules, e.g. real estate law has provisions on withholding rent as warranty of habitability or legality of the lease<sup>133</sup>.

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<sup>128</sup> *Particular Remedies For Non-Performance*, <https://www.law.kuleuven.be/personal/mstorme/c9-1.pdf>, D.A 5.5.2019, p. 502

<sup>129</sup> Mark P. GERGEN, "A Theory of Self-Help Remedies in Contract", *Boston University Law Review*, 2009, Vol. 89, p.p. 1397 – 1449, p. 1408.

<sup>130</sup> Mark P GERGEN, "The Law's Response to Exit and Loyalty in Contract Disputes" in N Cohen and McKendrick (eds) *Comparative Remedies for Breach of Contract*, Hart, Oxford, 2005, p. 76

<sup>131</sup> Mark P. GERGEN, "A Theory of Self-Help Remedies in Contract", *Boston University Law Review*, 2009, Vol. 89, p.p. 1397 – 1449, p.1411.

<sup>132</sup> GELLER, *ibid*, p. 178.

<sup>133</sup> GELLER, *ibid*, p.p. 165-166

Withholding performance also forms part of the duty to mitigate, which was proclaimed in case *Clark v. Marsiglia*. The rule is not applicable if an obligee has an interest in completing performance that damages cannot adequately compensate<sup>134</sup>.

American doctrine offers further development to this remedy, which would allow injured party withhold damages caused by default, but only in good faith, and would encourage breaching party to continue performance, minimizing risk of incomplete performance, and, at the same time, preserving continuation of the obligation/contract. In case of withholding or objection to such, the parties should exchange notices, which allow them both adjust performance<sup>135</sup>.

### **C. Withholding Performance in International Unification Sources**

The DCFR recognises withholding of performance as a sanction that may be exercised by the innocent party, where there is non-performance by the counter party, without first raising a court action and characterises it as defensive or a self-help remedy.

The DCFR regards the existence of reciprocal obligations in a contract as a factor of significance in the availability of withholding performance as a remedy for non-performance. It states that an obligation is reciprocal in relation to another obligation if: “(a) performance of the obligation is due in exchange for performance of the other obligation; (b) it is an obligation to facilitate or accept performance of the other obligation; or (c) it is so clearly connected to the other obligation or its subject matter that performance of the one can reasonably be regarded as dependent on performance of the other.”<sup>136</sup>

The DCFR provides two model rules about withholding performance, depending on whether the obligations are to be performed simultaneously or sequentially. In the first

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<sup>134</sup> Clark v. Marsiglia, 1845, D.A.23.5.2019, <http://www.lawnix.com/cases/clark-marsiglia.html>

<sup>135</sup> Mark P. GERGEN, “A Theory of Self-Help Remedies in Contract”, *Boston University Law Review*, 2009, Vol. 89, p.p. 1397 – 1449, p. 1418

<sup>136</sup> DCFR III.–1:102(4)

situation, i.e, where the performance is concurrent, neither has to perform until the other party has tendered performance<sup>137</sup>.

In the second situation, where the performance is reciprocal, the party who is to perform first may withhold performance if it reasonably believes that the other party will not perform when that performance when it falls due. It goes without saying that, that right is lost if the other party gives an adequate assurance of performance<sup>138</sup>.

The DCFR provides a default rule on the order of performance which applies if the sequence is not clear from the contract itself: *“If the order of performance of reciprocal obligations cannot be otherwise determined from the terms regulating the obligations then, to the extent that the obligations can be performed simultaneously, the parties are bound to perform simultaneously unless the circumstances indicate otherwise.”*<sup>139</sup>

The DCFR does not require that non-performance be in some sense material or fundamental before performance may be withheld<sup>140</sup>. This has then raised concern that a right to withhold performance might be abused, but this concerns may be allayed by the same DCFR, which embodies the concept of good faith and fair dealing in deploying a sanction for non performance.

Art. 71 CISG introduces right of withholding performance in case of anticipatory breach. According to Art. 71(1) CISG, a party may suspend performance of his obligations in case of anticipatory non-performance under certain circumstances.

Art. 71 CISG provides the grounds and conditions for suspending performance by any party due to the other party's anticipatory breach: *"A party may suspend the performance of his obligations if, after the conclusion of the contract, it becomes apparent that the other party will not perform a substantial part of his obligations as a result of: (a)*

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<sup>137</sup> DCFR III.-3:401(1).

<sup>138</sup> DCFR III.-3:401(2).

<sup>139</sup> DCFR III.-2:104

<sup>140</sup> DCFR III.-3:401

*a serious deficiency in his ability to perform or in his creditworthiness; or (b) his conduct in preparing to perform or in performing the contract."*

It is a logical condition that for the sanction of suspension of performance of an obligation to be in order, then the obligation to perform be already due. Hence it was concluded that the party who had to perform first was empowered to suspend performance. What are required are not only acts in performance of the contract, but also those in preparation of performance which, therefore, can also be suspended. As such, production of goods may be stopped and procurement of materials put off.

However, there is no right to suspend performance for insecurity in relation to performance obligations which are not substantial. Furthermore, to justify suspension of performance a threat of anticipatory non-performance of a substantial part of obligations must arise from: (a) a serious deficiency in his ability to perform or in his creditworthiness; or (b) his conduct in preparing to perform or in performing the contract.

According to Art. 9:201 PECL, the party may withhold performance until the other party tendered performance or performed, and this applies in situations where performance is simultaneously or reciprocal, i.e. after the counter-party. Article 9:201 further stipulates that performance can be withheld in whole or in part "as may be reasonable in the circumstances"<sup>141</sup>.

PECL makes clear that non-performance need not be "fundamental" and that the remedy of withholding performance can be used as a means of coercing the other party so long as the reaction is not "wholly disproportionate"<sup>142</sup>.

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<sup>141</sup> Damien NYER, "Withholding Performance for Breach in International Transactions: An Exercise in Equations, Proportions or Coercion?", *Pace Int'l L. Rev.*, 2006, Vol. 18, Iss. 29, pp- 29-81, p. 71.

<sup>142</sup> Nyer, *ibid* p.71.

## **D. Intermediate Conclusions**

The phrase “suspension of performance”, makes it clear that effect of this sanction, i.e, where the innocent party acquires a right not to perform its obligations, is temporary in nature.

In other words, even where one applies this sanction, and stops discharging their obligation, the contract is not terminated, and if the defaulting remedies its breach, the contract resumes its role as an active source of obligations for both parties.

As such it should be noted that “Suspension” and “termination” are distinct sanctions with a distinct effect.

In practice, suspension of performance is used most frequently as a form of self-help, deployed to coerce the debtor to complete performance rather than as a defence to a suit by the debtor. However, strictly construed, the suspension of ones obligation unde a contract, is a defence after a breach by the counterparty. The innocent party suspends its performance, the counterparty sues, contending that the suspension constituted a breach of contract, and the innocent party defends, citing the exceptio. In this way, the exceptio is literally an exception—an exception to the general rule of liability for non-performance.

Some justify that withholding is thus not exactly a sanction for breach of contract, but rather a temporary measure to prompt performance from another side. If the aggrieved party wishes to bring the contract to an end in case the requested obligation remains unperformed and she incurs expenses due to delay, she has to revert to the court for an order of resolution intended to end her own duty.

In my opinion, withholding is a right and an action, intended to secure party’s interests and the contract, persuading its performance, and saving external costs of legal enforcement, which ensures risk of the contractual breach, hence it qualification as a sanction is not erroneous.

Suspension of performance operates effectively as a self help remedy in a range of jurisdictions, and the value of permitting self-help in some circumstances is undeniable and civil law commentators acknowledge it; in fact it has been described by distinguished scholars as “the most notable” permissible form of self-help common to all civil law jurisdictions. Permitting suspension of performance also conforms to the civil law’s preference for solutions that preserve the contractual relationship<sup>143</sup>.

Self-help remedies are typically considered to be efficient, so long as they do not create windfalls for the parties invoking them. Where a breach is clear or is certain to occur, a creditor who accurately imposes a self-help remedy will save not only itself time and money (and therefore mitigate its losses), but the public as well, in the form of fewer court resources. Suspension of performance partakes of all of these advantages<sup>144</sup>.

## **VI. LIMITATION OF LIABILITY: LIQUIDATED DAMAGES AND PENALTIES**

Parties to commercial contracts commonly seek to set some parameters around what will happen in the event of a breach. They may for example agree a fixed sum that should be payable in the event of breach, or set a maximum sum for any damages.

Normally, these sanctions are included in contracts and stipulate the monetary relief available to a party in the event of breach. In other words, they assesses in advance the amount of damages for a breach of contract or so forth.

Liquidated damages are an amount contractually stipulated as a reasonable estimation of the actual damages to be recovered by one party if the other party breaches the agreement<sup>145</sup>.

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<sup>143</sup> Ugo DRAETTA Et al, *Breach and Adaption in International Contracts: an Introduction to Lex Mercatoria*, 1992, Butterworths Publishing, p.160.

<sup>144</sup> Mark P. GERGEN, “A Theory of Self-Help Remedies in Contract”, *Boston University Law Review*, 2009, Vol. 89, p.p. 1397 – 1449, p 1396.

<sup>145</sup> Gabrielle NATER-BASS and Stefanie PFISTERER, “Contractual Limitations on Damages” in *The Guide to Damages in International Arbitration*, 3rd Ed, Editor- John A Trenor, 2018, pp. 73-84, p.77.



On the other hand, penalty clauses are contractual provisions that assess against a defaulting party an excessive monetary charge unrelated to actual harm<sup>146</sup>.

## **A. Limitation of Liability: Liquidated Damages and Penalties in Civil Law**

As previously stated, liquidated damages are those of which the parties designate the amount during the formation of a contract, for the injured party to collect as compensation upon a specific breach. A penalty clause on the other hand, is also a lump-sum amount paid to the non-defaulting party. However, a penalty clause differs from a liquidated damages clause by not being tied to an estimate of possible actual damages. Broadly, a penalty is a sum above the actual damage amount incurred by a party required to be paid when a breach occurs<sup>147</sup>.

The Napoleonic Code, upon which most civil codes are based, allowed for penalties to encourage performance of contractual obligations. Moreover, traditionally, in Civil law countries, there was no distinction made between liquidated damages clauses and penalty clauses<sup>148</sup>.

Recently however, the frequent approach seems to distinguish between liquidated damages clauses that are used to estimate damages in case of non-performance, based on the concept that there has been an actual harm to the plaintiff, and penalty clauses that are used to establish a penalty to be paid in case of non-performance with the intent to encourage performance. The latter, as explained (penalty) does not require proof of any real damage, as it is more or less a punishment for failure to perform.

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<sup>146</sup> Bryan A. GARNER, *Black's Law Dictionary*, 10<sup>th</sup> Ed., 2014, p.1314.

<sup>147</sup> Hassan Ahmad, *The Enforceability of Penalties in Private Contracts*, D.A 5.6.2019, <https://www.lexology.com/library/detail.aspx?g=0c3ae94f-fbcc-467a-a194-1502cfa73657>

<sup>148</sup> Antonio Pinto MONTEIRO, "Clause Penale/Penalty Clause/ Verstragsstrafe," *European Review Private Law*, 2001, Vol. 1, pp.149-155, p.149.

Although penalty clauses have been generally enforceable in Civil law countries, they can now be mitigated by the court in most jurisdictions<sup>149</sup>. The Council of Europe issued a “Resolution on Penalty Clauses” in 1971, with the aim of recommending a uniform application of penalty clauses for the member states to use. The resolution, Resolution 78(3) of the Committee of Ministers of the Council of Europe, allows for penalty clauses, however, it provides that penalty amount may be reduced by the courts if they are manifestly excessive, or if part of the main contractual obligation of the contract has been performed.

The explanatory memorandum to the Resolution provides a list of factors in determining whether a penalty is manifestly excessive. They include a comparison of the penalty imposed to the actual harm; the legitimate interest of the parties, including non-pecuniary interests of the non defaulting party; what category of contract it is and under what circumstances it was concluded, with emphasis on the relative social and economic position of the parties; whether it was a standard-form contract; and whether the breach was in good or bad faith<sup>150</sup>.

Most Civil law jurisdictions seem to have followed the precedent of the Resolution to allow courts to reduce an excessive penalty. This is easily seen in statistics that show that there has been a widespread trend in recent years, in civil law countries, towards narrowing the scope of such penalties, and allowing courts to reduce the amount if they find it excessive.

In France, Articles 1231-5 of the FCC regulates “la clause penale” (penalty clause), and Art. 1152 regulates “dommages-interets” (liquidated damages). The former may be reduced by a judge if part of the main contract obligation has been performed and if it is “manifestly excessive.” Liquidated damages may also be adjusted if “obviously excessive or ridiculously low.

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<sup>149</sup> Scottish Law COMMISSION, *Penalty Clauses*, 1999, p. 2-3.

<sup>150</sup> Larry A. DÍMATTEO, “A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages”, *American Business Law Journal*, 2001, Vol. 38, p.p. 633 – 732,p.653.

In Italy, both concepts, “clausola penale” (penalty clause) and “liquidazione convenzionale del danno” (liquidated damages), exist in doctrine. Penalties are generally enforceable but can be mitigated if such penalty is quite obviously harsh/excessive or in the event part of the main contract obligation has been performed<sup>151</sup>.

Germany makes distinction between liquidated damages (Schadenspauschale) and contractual penalties (Vertragsstrafe) in the German Civil Code. While both of these sanctions are allowed according to Article 340 and 341 of the BGB, the difference between them is that the latter can be mitigated if “disproportionate or excessively high.”

Another civil law country is Turkey, which we will look at slightly more in detail. Under Turkish law, the concept of liquidated damages is recognized and in practice the concept of “penalty” is commonly used<sup>152</sup>.

Penalty clauses are regulated under the TCO6098/2011, and the law recognizes three main functions of penalty clauses; compelling performance (a party fearing the penalty that may occur, shall be forced to fulfil his part of the promises), estimating damage (penalty clauses are to provide some form of compensation to the innocent, and as such it generally bears in mind an estimation of the damage that occurs) and simplifying unilateral cancellation (penalty clauses normally stipulate in the agreement what events constitutes breach and will call for immediate contract termination)<sup>153</sup>.

Penalty clauses are due when the principal debt and/or obligation is not performed at all or is not performed appropriately or on the agreed time and place<sup>154</sup>. In cases where the parties designate a penalty clause, the party failing to fulfil its penalty-related obligations completely and/or properly, is under obligation to pay a penalty amount to the

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<sup>151</sup> Article 1184 in Codice Civile regulates penalty clauses.:The Codice Civil is Italy’s Civil Code.

<sup>152</sup> Kesikli Hukuk BÜROSU, *The International Comparative Legal Guide to: Construction & Engineering Law; Construction and Engineering Law in Turkey*, D.A 30.5.2019, <https://www.kesikli.com/construction-and-engineering-law-in-turkey/>, ,

<sup>153</sup> M.TİRYAKİ, *Penalty Conditions in Private Law Regime*, 2005, Istanbul, IstanbulKültürÜniversitesi, p.26

<sup>154</sup> Erol CANSEL,& Çağlar OZEL, *Türk Borçlar Hukukunda Ceza Koşulu - Penalty Clauses under the Turkish Law of Obligation*, 2007, D.A.27.6.2019, <https://journal.yasar.edu.tr/wp-content/uploads/2014/01/19-E.CANSEL-%C3%87.-%C3%96ZEL>

other party even if there is no damage incurred as a result of such failure. Courts do not have a duty to examine whether the sum to be paid is a genuine pre-estimate of loss. The sum of the penalty might be wholly unrelated to the amount of the financial loss suffered. However, courts have the power to decrease the amount of penalties under certain circumstances.

In the Ex-Turkish Cod of Obligation, the term “Tediye” used to indicate that the value of the penalty could only be of monetary value<sup>155</sup>. Under the New Code, however, it is not required to be a monetary sum. It even may be refraining from doing a certain act or benefiting from a certain thing. But, things that have only moral values may not be agreed as a penalty value for they may not be executed through specific performance<sup>156</sup>.

Moreover, under Turkish law, there are some obligations that may not be secured by penalty clauses. For instance, Penalty clauses are not allowed to secure obligations that are related with the privacy and/or personal matter of a person like penalty clauses in relation with promises to marry are invalid under the Turkish law. Also, Penalty clauses against weaker parties in some contractual relations are not also enforceable<sup>157</sup>. Under the Turkish law, it is not legally possible to provide a penalty clause that is against only the employee in a contract of service, or against only the tenant in contract of rent, for not paying the rent fee on time and, in contract of agency, for unilaterally cancellation of the agency contract, as is stipulated in Articles 346, 420, 512 of the TCO(TBK).

Further, it is important to note that under the Turkish law, particularly under article 179 of the TCO, the innocent party in a contract may require both the performance and the penalty if the clause stipulates so, otherwise an innocent party may claim either the performance or the penalty<sup>158</sup>.

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<sup>155</sup> Ahmet KILIÇOĞLU, *Borçlar Kanunu, Genel Hükümler-General Provisions of the Law of Obligation* 19<sup>th</sup> Ed., Ankara, Turhal KitabEvi yayınlar, 2015, p.75.

<sup>156</sup> Fikret EREN, *Borçlar Hukuku Genel Hükümler [The Code of Obligations General Provisions]*, 16<sup>th</sup> Ed., Ankara ,2014, p. 216.

<sup>157</sup> CANSEL & ÖZEL, *ibid.*

<sup>158</sup> Kamil Abdu OUMER, 2017, “Penalty Clauses: A Comparative Analysis between the Turkish and Ethiopian Laws”, *Beijing Law Review*, Vol. 8, pp. 423-439, p 429.

## **B. Limitation of Liability: Liquidated Damages and Penalties in Common Law**

Common-law jurisdictions have made a clear cut distinction between liquidated damages and penalties. While traditionally, common law courts have upheld liquidated damages clauses, the common law rejects penalty clauses in contractual obligations in its totality. This is because penalty clauses are punitive in nature i.e, disciplinary and intended as a punishment, and as such the common law position is that any agreement between parties whose main objective is to punish either party is unacceptable<sup>159</sup>.

The sole purpose of liquidated damages is to provide a method for calculating damages that would be otherwise difficult to prove. As earlier mentioned liquidated damages are pre determined damages that a party should pay in the event of breach, and the calculation of this is based on the actual harm the innocent party is likely to suffer. As such the common law position is that these liquidated damages ought to be consistent with the harm actually suffered. Where liquidated damages provided in a contract are not proportionate to the real or anticipated loss, the common law courts can decide they are a penalty. If the court determines the damages are actually a penalty, the provision will be voided, and the injured party will only be able to pursue actual damages caused by the contract being breached.

The long standing belief in common law is that an injured party should not be entitled more than what s/he would have gained had the contract been performed<sup>160</sup>. Penalty clauses which are agreed, are a form of intimidation, meant to coerce the defaulting party to perform, and are as such un-enforceable.

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<sup>159</sup> Gassim OBEIDAT Et.al, 2004, "The "Penalty" Clause in English Law: A Critical Analysis and Comparison with Jordanian Law", *PHD Thesis, Leeds: University of Leeds*, p. 117.

<sup>160</sup> Jonathan S. SOLORZANO, 2009, "An Uncertain Penalty: A Look at the International Community's Inability to Harmonize the Law of Liquidated Damages and Penalty Clauses", *Law and Business Review of the Americas*, Vol. 15, Iss. 4, pp. 779-818, p.800.

However, the line between liquidated damage and penalty clause is sometimes blurred that courts may enforce some penalty clauses as liquidated damages and may reject some liquidated damage clauses as penalties, and as such different countries in common law jurisdiction have put in guidelines to ensure that penalties are not enforced<sup>161</sup>.

The American approach to liquidated damages can be illustrated by both the UCC and the Restatement (Second) of Contracts. In the Restatement (Second) of Contracts, Section 356 (1), states that damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

The UCC § 2-718 (1), states that damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

Most other common law countries such as England, Australia, Ireland and Canada have similar rules as the USA with regard to liquidated damages, and do not allow for liquidated damages that are used as a penalty.

There will be minor differences in how jurisdictions will treat liquidated damages provisions and try to distinguish them from penalty. However, in general, there are important factors which determine if the provision is valid. First, it should be the intention of the parties to designate, in advance, the amount of potential damages due in the event of the non-performance of the obligations of a contract. If the clause intends to secure performance, it is penalty and, if it intends to estimate damages, it is liquidated damage<sup>162</sup>. Secondly, the agreed sum should also be a reasonable estimation of the expected loss, in

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<sup>161</sup> SOL'ORZANO, *ibid*, p. 82.

<sup>162</sup> Peter BENJAMÍN, "Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law", *The International and Comparative Law Quarterly*, 1960, Vol. 9, Iss. 4, pp. 600-627, p. 611.

the event its reasonable common law courts may enforce it. The liquidated damage is enforceable if it is a reasonable estimation of the possible future loss from the non-performance of the obligation even if no actual loss occurred<sup>163</sup>. In short, common law jurisdictions generally only allow liquidated damages, where the clause is deemed to be a penalty clause, i.e the amount is not proportional to the harm; it will not be enforceable in most common law jurisdictions.

### **C. Limitation of Liability: Liquidated Damages and Penalties in International Unification Sources.**

According to the UNICITRAL rules, an agreement between parties of a contract to pay a certain sum in the event of non-performance is generally allowed, whether as a penalty or compensation. However, the amount can be reduced by the courts if it is “substantially disproportionate to the actual loss”<sup>164</sup>.

Moreover, UNCITRAL in the Text of Draft Uniform Rules on Liquidated Damages and Penalty Clauses allows cumulative penalty, where it explicitly stated in the contract and agreed by the Parties (1981)<sup>165</sup>. Cumulative penalty clauses enable the creditor to claim both the performance of the obligation and the penalty in case of non-performance.

Further, as previously explained, the Council of Europe adopted Resolution (1978) on Penal Clauses in the Civil Law, which stipulated judicial control over manifestly excessive penal clauses and reformation of the latter. Factors of determination included the following: 1) comparison of the pre-estimated damages with the actual damages suffered; 2) legitimate interests of the parties, covering the non defaulting party’s non-pecuniary

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<sup>163</sup> Gerrit De GEEST & Filip WUYTS, Penalty Clauses and Liquidated Damages, 1999, D.A 24.5.2019, <https://reference.findlaw.com/lawandeconomics/4610-penalty-clauses-and-liquidated-damages.pdf>

<sup>164</sup> Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance and Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance. Official Records of the General Assembly, Thirty-eighth Session, Supplement No 17 (A/38/17, annexes 1 and 2), article 9

<sup>165</sup> Ignacio M. GARCÍA, “Enforcement of Penalty Clauses in Civil and Common law: A Puzzle to be Solved by the Contracting Parties”, *European Journal of Legal Studies*, 2012, Vol. 5, Iss. 1, pp. 98-123, p. 113.

interests; 3) category of contract and its standard nature; 4) circumstances in which contract was made, bargaining positions of the parties; 5) was the breach in good or bad faith<sup>166</sup>.

The PECL on the other hand, does not include explicit rules of either penalty or Liquidated damages. However, Art. 9:509(1) PECL talks about “*agreed payment for non-performance*,” which is more or less similar to characteristics of both the Penalty and Liquidated damages. The PECL, through this Article states that the aggrieved party should be awarded the sum, specified in the contract in case of non-performance, irrespective of its actual loss. Nevertheless the specified sum may be reduced to a reasonable, if is grossly excessive in relation to the actual loss and other circumstances (Art. 9:509(2) PECL).

Similarly to BGB, Art. 8:102 PECL does not deprive a party of its right to demand cumulative remedy. Also. Art. 8:109 PECL allows clauses excluding or restricting remedies “unless it would be contrary to good faith and fair dealing”, and this further cements the idea that liquidated damages and/or penalty clauses, even though not clearly stipulated for in the law, are allowed <sup>167</sup>.

Analogous to PECL, the DCFR under Art.III-3:712 DCFR defines the liquidated damages and Penalty as “*stipulated payment for non-performance*”, to which the innocent party to a contract is entitled irrespective of the actual loss, but which may be reduced to reasonable amount in a way, in the event it is too severe. The explanatory note of this Article states that the purpose of the penalty clause is to coerce performance of the principal obligation, while Liquidated damages aim is to pre-estimate future creditor’s loss due to non-performance.

Similarly to PECL, Art.III-3:703 DCFR limits liability to foreseeable loss “at the time when the obligation was incurred” (unless the non-performance was intentional, reckless or grossly negligent). Art.III-3:102 DCFR also permits for cumulative remedies

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<sup>166</sup> Larry A. DÌMATTEO, “A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages”, *American Business Law Journal*, 2001, Vol. 38, p.p. 633 – 732,p. 652.

<sup>167</sup> European COMMISSION, *Justice and Fundamental Rights*, D.A 24.5.2019, [https://ec.europa.eu/info/policies/justice-and-fundamental-rights\\_en](https://ec.europa.eu/info/policies/justice-and-fundamental-rights_en)



(i.e Penalty in addition to other sanctions). However, in the official notes to the article it is stated that stipulated payment replaces damages.<sup>168</sup>

CISG does not have express penalty or liquidated damages provisions<sup>169</sup>. From one point of view, reference to liquidated damages may be assumed under Art. 74 CISG: “*Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract*”. Emphasis being made on the phrase; sum, which the party ought to have foreseen at the formation of the contract. Nevertheless traditional view is that under CISG (Art. 4) validity of penalty clauses shall be determined based on national laws<sup>170</sup>.

#### **D. Intermediate Conclusions**

Even though the development of liquidated damages and penalty clauses seems to be moving toward a more uniform approach, a contract clause for an amount to be paid by one party for non-performance or breach of contract will still be met with a different response in common law versus civil law jurisdictions. In a common law jurisdiction, such a clause will not be enforced if it is not reasonable in proportion to the actual or anticipated damage, and if it is designed to penalize the breaching party. In civil law jurisdictions, the assumption is that a penalty clause is enforceable, and the aspect of sustaining actual loss is not a condition to claim the stipulated sum, however the penalty may be reduced if it reaches a certain level of excessiveness<sup>171</sup>.

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<sup>168</sup> European COMMISSION, *Justice and Fundamental Rights*, D.A 24.5.2019, [https://ec.europa.eu/info/policies/justice-and-fundamental-rights\\_en](https://ec.europa.eu/info/policies/justice-and-fundamental-rights_en)

<sup>169</sup> Bruno ZELLER, “Penalty Clauses: Are They Governed by the CISG?”, *Pace International Law Review*, Vol. 23, Iss.1, 2011, pp. 1 – 14, p.8.

<sup>170</sup> John O. HONNOLD, Harry M. FLECHTNER, *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International Publishers, 2009, p.73 .

<sup>171</sup> Manfred PIECK, “A Study of the Significant Aspects of German Contract Law”, *Annual Survey of International and Comparative Law*, 1996, Vol. 3, Iss.1, pp. 111 – 176, p. 134.

Nonetheless, contractual limitations on damages are of critical importance, as they set beforehand, what the exact form and value of consequences that shall follow, in the event of a particular breach, hence allowing parties to better assess and control business risks arising from a commercial transaction<sup>172</sup>.

In fact, there are several reasons the use of Liquidated damages clauses in construction contracts are preferred. First, it allows for administrative convenience, because the contract, in itself, through the Liquidated damages clause, clearly stipulates the specifics of the sanction that is to occur. As such, parties are often spared the need to take their time and incur the expenses of litigation. In the event litigation does take place, then the burden is upon the party challenging it to show good cause for venturing outside the confines of this agreement. Secondly, the Liquidated damages clause protects the contractor such that they are able to project/know the most it would cost in the event of a full application of the Liquidated damages clause, hence allowing them to make the necessary arrangements. Third, a Liquidated damages clause can function as a deterrent to the contractor to not delay in completing a given project or as an incentive to complete a project within a given time frame under given circumstances, and make a greater profit as a result.

To conclude, it has also been argued that one of the advantages of liquidated damages/penalty clauses is that they relieve the court from calculation of damages especially so in non-calculable and non-material damages, because as a liquidated damages clause, it creates certainty and specificity on the value of the sanction<sup>173</sup>.

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<sup>172</sup> Jack GRAVES, "Penalty Clauses and the CISG", *Journal of Law and Commerce*, 2012, Vol. 30, Iss.2, pp. 153-172, p. 165.

<sup>173</sup> DE GEEST & WUYTS, *ibid*

## CHAPTER THREE

### REMEDIES UNDER INTERNATIONAL STANDARD CONSTRUCTION CONTRACTS

#### I. INTERRELATION BETWEEN CONTRACTS FOR SALE OF GOODS AND PROVISION OF SERVICES

A contract for sale of goods is an agreement relating to the sale of items or rather goods. On the other hand, a Contract for provision of devices, is an agreement regarding to the performance of a task or service<sup>174</sup>.

While contracts for goods and service contracts are share a lot of similarities, in that they both place legal obligations on contracting parties and incorpoarete the aspect of consideration, however, in most jurisdictions, the laws governing these types of contracts, and more specifically the sanction measures applied when the contractual obligations are not fulfilled do vary.

Construction contracts in particular demonstrate a complex and challenging case of interrelation of sale of goods and service<sup>175</sup>. These sort of contracts that contain a mixture of goods and services, are commonly known as “hybrid” contracts.

In order to understand the extent to which such contracts can be governed by sales’ law, including international norms, and to which extent they are exempted from it, I shall refer to the provisions of CISG. This particularly because the adoption of CISG has influenced most of the national sales’ laws and provided for their modification and/or harmonization in both civil and common law jurisdictions.

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<sup>174</sup> The Fordham Law Archive of Scholarship and History, “Contracts for Services Distinguished from Those to Sell Goods”, *Fordham Law Review*, 1946, Vol. 15, p. 92,  
<https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1300&context=flr>

<sup>175</sup> The Fordham Law Archive of Scholarship and History, *Ibid.*

Article 3 of CISG is one of the provisions that defines the field of application of this Convention. It considers its application to extend to contracts for the supply of goods to be manufactured or produced unless the buyer undertakes to supply a substantial part of the materials necessary for the manufacture or production, which is then viewed as being not a contract for the sale of goods, and maybe a contract service. Further, Article 3(2) CISG states that the Convention can apply to mixed contracts, but it will not apply to mixed contracts where the preponderant part of the obligations of the party who furnishes the goods consists of labour or other services.

Accordingly and pursuant to the Secretariat's commentary to the Article 3 of CISG (1978 Draft), two cases shall be distinguished and treated separately from the regular sales; (i) Where the materials supplied by the buyer are not themselves the substantial part of the materials necessary to manufacture the goods (and therefore, under Article 3(1), the CISG would apply), but if they form a substantial part then they are not treated as sale of goods (ii) where the labour or other services to be provided by the seller of goods, are not the preponderant part of the mixed contracts (so that, under Article 3(2), CISG would also apply to this part), if otherwise i.e. if the preponderant part of the obligations of the party who furnishes the goods consists in the supply of labour or other services then CISG would not apply<sup>176</sup>.

Distinguishing contracts for the sale of goods from services contracts is a highly controversial issue under many domestic legal systems, take for instance work/service contracts in which one of the parties provides the necessary materials for the construction by the other party (contracts for works and materials). Although the different legal systems would almost unanimously consider such a contract to be a work contract (when the buyer [project owner] provides all or a substantial part of the materials), but when the seller

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<sup>176</sup> John O. HONNOLD, *Uniform Law for International Sale under the 1980 United Nations Convention*, 3<sup>rd</sup> Ed., 1999, Kluwer Law International Publishers, Hague, p. 58.

(contractor) provides them, different solutions are considered: sales contracts, work contracts, or even mixed contracts<sup>177</sup>.

In comparison to the diversity of approaches encountered in domestic law, the Convention adopts two criteria of distinction, "substantial part" (Article 3(1) CISG) and "preponderant part" (Article 3(2) CISG). Therefore, while under many domestic laws such contracts would not be considered to be sales of goods contracts, the Convention considers as sales contracts, contracts for the supply of goods to be manufactured or produced by the seller with materials provided by him or by the buyer if the buyer undertakes to provide some but not a substantial part of the materials necessary for the manufacture or production (Article 3(1) CISG).

The Convention in adopting the dividing criteria: "substantial part" and "preponderant part", has led to several interpretations. Regarding the first case, a number of academics states that term "substantial" refers solely to economic value: in order to outlaw CISG buyer-provided materials should be higher in value (price) than seller-supplied<sup>178</sup>; such opinion is supported in some court awards. CISG Advisory Opinion on the other hand recommended disregarding fixed percentages, but rather the basis of what is substantial should be founded in an overall assessment and on case-by-case basis.

Moreover, there exist some writers as well as some courts that suggest the need of using the "essential" criterion when trying to assess or apply the substantial part, i.e. they state that substantial should be assessed based on the evaluation of quality/functionality of the provided materials. This idea is actually invoked by different languages' versions of the Convention: While the English version uses "substantial" the French version uses "part essentielle". Section 2.5 of the commentary to the CISG Advisory Opinion establishes that "economic value" criterion should prevail (section 2.6) and criterion "essential" should be considered only where "economic value" impossible or inappropriate to apply (section 2.7).

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<sup>177</sup> Ulrich G. SCHROETER, "Vienna Sales Convention: Applicability to "Mixed Contracts" and Interaction with the 1968 Brussels Convention", *Vindobona Journal of International Commercial Law and Arbitration*, 2001, Vol. 5, pp. 74- 86, p. 75,

<sup>178</sup> Bradley J. RICHARDS, "Contracts for the International Sale of Goods: Applicability of the United Nations Convention", *Iowa Law Review*, 1983, Vol. 69, pp. 209 – 240, p. 227.

Therefore three tests in determination of “substantial part” can be assumed under CISG: 1) dominant economic value (ex ante); 2) supplementary essential test (effect of the contribution to the end-product); 3) case-by-case approach, - all of which can be used individually, cumulatively, or successively. Additionally “necessity” of supplied materials for the end-product production as such should be assessed; materials for packaging, transportation and acceptance tests should be excluded from the consideration since they do not form part of the end-goods<sup>179</sup>.

Where a buyer, or in the construction arena- the project owner, supplies the designs, drawings, technical specifications, technology and formula, it then becomes questionable in terms of substantial material contribution. The CISG normally covers them, but the general approach by various legislation and scholars is that indeed, they may come under consideration if they significantly increase end-product value<sup>180</sup>. It is such approach that has led to the holding of ancillary services, such as packaging, dispatching, transportation, unloading, insurance, waste management, even “major engineering effort and planning and conceptual work”, provided by the buyer/project owner in a construction scenario as to be excluded from the consideration of the mixed contracts (second case), and even when a contract contains all this, it should nonetheless be treated a sale of goods. The Dominant opinion in doctrine and case law is that “preponderant” should be qualified based on the overall assessment (not percentages or quantity), and where economic value criterion (applied ex ante) should prevail and “essentiality” may contribute when necessary<sup>181</sup>.

Confusion however exists in how the different national legislation choose to apply the CISG and their interpretation of “substantial” and “preponderant”, and this confusion is further heightened by the commentary to the sub-section 3(2) CISG, providing as an example of exclusion a contract. It states that in a contract where the seller agrees to sell machinery and undertakes to set it up in a plant in working condition or to supervise its

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<sup>179</sup> Jelena PEROVI, “Selected Critical Issues Regarding the Sphere of Application of the CISG”, *Belgrade Law Review*, 2011, Iss.3, pp. 181- 195, p. 185

<sup>180</sup> PEROVI, *ibid*, p.p. 186 – 187

<sup>181</sup> PEROVI, *Ibid*

installation, if the “preponderant part” of the obligation of a seller consists of the supply of labor or other services, then such contract is not subject to the provisions of the Convention<sup>182</sup>. Some courts require that the value of the service obligation “clearly” exceeds that of the goods and where the obligation regarding the supply of labour or services amounts to more than 50% of the seller’s obligations, failure to which the Convention is inapplicable.

On the basis of this reasoning, several courts stated that a contract for the delivery of goods providing also for the “seller’s” obligation to install the goods is generally covered by the Convention, since the installation obligation is generally minor in value compared to the more traditional “sale” obligations.

Many courts in reviewed European jurisdictions and US have however refused to apply CISG in cases of installation or construction of the industrial plant, and other turn-key contracts. Other courts, however, treat them as sales of goods. Hence the matter of qualification of the turn-key contract is unsettled and requires case-by-case analysis, which creates high legal uncertainty.

Turnkey contract is one relating to a project that is constructed so that it can be sold to any buyer as a completed product. While one court stated that turn-key contracts are governed by the Convention except when the obligations other than that of delivering the goods prevail from an economic value point of view, several courts stated that turn-key contracts are generally not covered by the Convention, because turn-key contracts “do not so much provide for an exchange of goods against payment, but rather for a network of mutual duties to collaborate with and assist the other party”. Therefore, seeing the uncertainty of the courts, it is recommended to the parties resolve the matter in the contract by explicitly excluding application of the Convention pursuant to Art. 6 CISG.

In fact in order to avoid qualification of the international construction projects under CISG or local sales laws and following uncertainty and instability, number of international

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<sup>182</sup> Section 3.5 of the CISG Advisory Council Opinion No4, Contracts for the Sale of Goods to Be Manufactured or Produced and Mixed Contracts (Article 3 CISG).

and national industrial organizations developed respective standards of general terms and conditions directed at regulation of specific relationships in multiparty construction projects.

## **II. DEVELOPMENT OF STANDARD CONSTRUCTION CONTRACTS**

When two parties enter into any agreement, and in this instance a construction contract, among other relevant provisions in their contract, they will take some time contemplating on what is to happen if things go wrong, and make provisions covering such instances. While no party ever enters into an agreement with the expectation that things will go awry, this situation do arise. Moreover, as contracts and business relationships grow more complex over time, there is a greater chance that things in a contractual arrangement may go wrong. With this in mind, there are various ways in which parties can work through their disputes when they arise, and they usually set forth in their contract what is to ensue in the event a breach of any particular term occurs<sup>183</sup>.

In this context, in light of the increased globalization, and with construction contracts being a good example of contracts that operate in the international environment characterized by conflict of jurisdictions, standard form of constructions contracts to govern contracts in the construction realm, have developed overtime. Accordingly, many parties, taking advantage of the contractual freedom provided in most legal systems, which allows parties to agree in their contract the form, extent and measure of remedies, provide for these standard terms of construction contracts to apply in their contracts i.e. FIDIC.

FIDIC is one of the main international doctrines that governs international construction contracts. The Associated General Contractors of America and the Federation of Americana de la Industria de la Construction in USA initiated probably the first contracts designated for the international construction. Fédération Internationale Des

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<sup>183</sup> Tracy A. THOMAS, “Ubi Jus, Ibi Remedium: The Fundamental Right to a Remedy under Due Process”, *San Diego Law Review*, 2004, Vol. 41, p.p. 1633 – 1646, p. 1640



Ingénieurs-Conseils (International Federation of Consulting Engineers), established in 1913 in Geneva by French, Belgium and Swiss association of engineers, with participation of wide number of new members published its first edition of the Conditions of Contract (International) for Works of Civil Engineering Construction in August 1957<sup>184</sup>.

There is number of other standard agreements in the industry, which have solid reputation and wide acceptance in the same business area. For instance ORGALIME (The European Engineering Industries Association, with headquarters in Brussels, representing the interests at the level of the EU institutions of the European mechanical, electrical, electronic and metal articles industries) in 2003, published Turnkey Contract for Industrial Works, which was claimed to be more balanced alternative to the FIDIC Silver Book, which also deals with industrial works<sup>185</sup>.

Accordingly, and as above mentioned, in practice usually the standard terms or general conditions are used as a basis, auxiliary or supplementary contractual document to the main agreement. Such main agreement between the parties is called in terms of FIDIC Silver Book (“FIDIC”) “Contract Agreement” and “Particular Conditions” (Sub-Clauses 1.1, 1.5 and 1.6) or in terms of ORGALIME Turnkey contract (“ORGALIME”) “Main Contract Document” (Sub-Clause 2.2).

Generally speaking, standard international construction contracts provide a number of different potential sanctions which are to follow in the event of breach of contract. Some of the damage measures are monetary, as it will be necessary for a party to be compensated for some consequential loss. Other measures involve specific performance, where a party is ordered to distinctly do something that has been demanded by the contract. Sanctions in international construction contracts have a basis in both law and equity. They are designed to reflect public policy goals at their outset because contracting is a chief basis through which business gets done. With this in mind, this chapter will provide an overview of these remedies. It looks at a variety of monetary-based sanctions in contract, specific

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<sup>184</sup> Jeremy GLOVER, *FIDIC an overview: the latest developments, comparisons, claims and a look into the future*, D.A.4.6.2019, <http://www.fenwickelliott.co.uk/files/FIDIC.pdf>.

<sup>185</sup> FIDIC Conditions of Contract for EPC/Turnkey Projects, 1st Ed., Geneva, 1999, p.55.

performance, penalty clauses, liquidated damages provisions, price adjustments, the withholding of either money or performance, and even the termination or rescission of a contract<sup>186</sup>.

As earlier stated sanctions for contract breach are designed to be somewhat broad and accommodating in nature, because contracts themselves can vary. While some might think that the goal of remedies is always to make parties whole, it is often the case that the remedies are designed to ensure that parties have incentives to actually perform and to deal fairly with one another<sup>187</sup>. Thus, it is often times true that contracting remedies are there to push the parties to come to agreements that are most fair and most economically efficient, too. This is why one will see some parties available themselves to equitable remedies, while other parties will seek termination or compensation whenever there is a dispute. Parties can choose the sort of remedies they would like to avail themselves of in a given situation, but it is also true that courts will try to choose the remedy that is the fairest and more equitable in a given situation. With this in mind, various options available to both employers and contractors are discussed in turn, looking at relevant international doctrine, including FIDIC and ORGALIME<sup>188</sup>.

Nonetheless, it important to note that all legal systems despite providing for contractual freedom, usually do have default or mandatory provisions, which may or may not be circumvented by the contract terms<sup>189</sup>.

Take for instance in Germany, there exists a standard of construction contract procedures (General Terms and Conditions) formed out of 26 documents and is known as the VOB (*Vergabe- und Vertragsordnung für Bauleistungen*). Any contractual relationship relating to a construction performed for public needs, in addition to BGB the same is also

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<sup>186</sup> Robert KNUTSON, Wilfred ABRAHAM, *FIDIC: An Analysis of International Construction Contracts*, Wolters Kluwers Publishers, 2005, p. 78.

<sup>187</sup> Damian MCNAIR, *International Best Practice in Project and Construction Agreements*, 2012, [http://www.dlapipercentralcms.com/export/system/central-cms/publications/files/2013/projects-andinfrastructure/International\\_best\\_practice\\_in\\_projects\\_and\\_construction\\_agreements.pdf](http://www.dlapipercentralcms.com/export/system/central-cms/publications/files/2013/projects-andinfrastructure/International_best_practice_in_projects_and_construction_agreements.pdf).

<sup>188</sup> MCNAIR, *Ibid*.

<sup>189</sup> Robert KNUTSON and Wilfred ABRAHAM, *FIDIC: An Analysis of International Construction Contracts*, Kluwer Law International Publishers, 2005, p. 78

governed by the VOB (2012). Private parties are given the liberty of choosing to apply VOB , and they may do so by the mere reference in the contract, as well as modify and adopt deviation or use other forms of contract, including FIDIC, which are also qualified as general terms and conditions (“GTC”) under German law<sup>190</sup>.

Germany, like many other countries , require that the GTC used within German legal system should comply with special requirements of statutory law. According to §307 of the BGB provisions in standard business terms become invalid if among other requirements, are not compatible with the essentials principles contained in statutory provisions. In short, where parties to a construction contract choose to apply FIDIC, and particular FIDIC provisions are contrary to the mandatory rules in Germany, then these FIDIC provisions will be void and null<sup>191</sup>. To clarrify, this principle is embodied in almost all jurisdictions, the mandatory provisions of a country will always take precedence over any FIDIC provisions which usually form part of the general terms and conditions.

Nonetheless, for emphasis, and as earlier mentioned, these general terms and conditions contained in the standard construction agreements, usually provide a high level of unification and harmonization of legal norms from various legal orders<sup>192</sup>. Additionally, they demonstrate successful fusion of borrowed rules into integrated system of remedies, serving both national and international contracting.

As such, we shall now analyze the specifics of each earlier studied sanction in the context of several industrial standards applied globally, moe particularly FIDIC and Orgalime, and observe how they apply the same<sup>193</sup>.

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<sup>190</sup> PIECK, *ibid*, p.134.

<sup>191</sup> KNUTSON and ABRAHAM, *ibid*, p. 92

<sup>192</sup> KNUTSON and ABRAHAM, *ibid*.

<sup>193</sup> PIECK, *ibid*, p.133.

### **III. SPECIFICS OF SOME REMEDIES UNDER STANDARD CONSTRUCTION CONTRACTS**

#### **A. Specific Performance and Substitute Performance**

Construction contracts are such that it is often critical to ensure that the two sides actually complete the deal because no other option would be fair or suitable for those involved. Likewise, in some contracts, money damages are just not good enough to fully compensate a company for the breach. Take, for instance, the case of a company that had specifically contracted with a highly skilled construction company to work on a project. If that highly skilled construction company refused to do the work, then it would be difficult to come up with a financial measure to figure out just how much the first company had been harmed. While the law does try to provide ways in which money can be used to fix all problems, there is some understanding that money simply cannot cure all ills. This means that courts in the international construction contract context do have the ability and the power to order other remedies in order to actually make the situation right.

Specific performance essentially means that the court has the ability, in some instances, to order a party to fulfill its end of the bargain. It can order a company to actually undertake its obligations on a project or to pay out as promised, assuming this is possible. There is, in some cases, a preference against these kinds of remedies. For instance, in the context of employment contracts, courts do not like making parties work together when their relationship has deteriorated to the point that one or both of them no longer want to do so. It would be difficult, for instance, to order a writer to continue writing the autobiography of another person when those two had gone through a serious financial conflict. This leads to some discussion of a murky middle ground with insurance contracts. Insurance contracts are not traditional employment contracts. There is a big difference between one company contracting with another to perform a service and individuals working together on a project.

International construction contracting standards suggest that specific performance is a remedy that is appropriate for these sorts of deals. Contracts completed according to the

expectations of the FIDIC have been held by the courts to be amenable to specific performance, meaning parties are sometimes required to uphold their end of the bargain when one might otherwise just order a financial payment to correct the problem.

Sub-Clause 4.1 FIDIC, defines Contractor's contractual obligation as follows: "design, execute and complete the Works in accordance with the Contract, and ... *remedy any defects in the Works*". Sub-Clause 11.1 FIDIC further provides for a Defect Notification period. This is generally a certain number of day counted from the date of completion of works (FIDIC states that this period is generally one year may be extended under Sub-Clause 11.3 Extension of Defects Notification Period) that allow the customer/project owner to notify defects and or damages in a building to the Contractor. FIDIC, obligates the Contractor by the end of the Defects Notification Period to "execute all work required to remedy defects or damage, as may be notified by the Employer on or before the expiry of the" said period.

Further, according to Sub-Clause 5.8 FIDIC, all defects in the Contractor's works should be corrected at the Contractor's cost. This is further emphasized by Clause 11.2 FIDIC which provides that all defects in the design of the Works, Plant, Materials or workmanship, as well as improper operation or maintenance attributable to the Contractor should be remedied at the risk and cost of the Contractor. If the Contractor fails to comply with the Employer's/project owner's request for the Remedial Work, the Employer is entitled to employ and pay other persons (at the Contractor's cost) to carry out the work (Sub-Clause 7.6 FIDIC). Sub-Clause 9.2(3) FIDIC provides that in case the Contractor fails to carry out Completion Tests within 21 days' period upon notice from the Employer, the Employer's personnel may proceed with the Tests at the risk and cost of the Contractor. Sub-Clause 11.4 FIDIC also emphasizes the latter point, it provides that the Employer-who is also called the project owner, with various options in case of the Contractor's failure to remedy defects, including the possibility to carry out work himself or by others, in a reasonable manner and at the Contractor's cost (but in this case not his risk).

Other similar provisions that seem to encourage for the need of the Contractor to fulfill his obligations as per the contract (specific performance) is Sub-Clause 18.7 ORGALIME. It provides that in the event the Purchaser is in delay for removal from the Contractor's premises of his materials upon termination, then the Contractor is entitled to remove them to a suitable location for storage at the Purchaser's cost and risk.

Another remedy, which often comes in equity, is substitute performance. Generally speaking, substitute performance is using an alternate method to the one provided for in the contract terms in order to fulfill the obligations under the contract. As mentioned, one of the chief goals of the courts in dealing with contract disputes is finding a way to ensure that parties efficiently work out any problems that they have. This means that they may order substitute performance, or they may uphold clauses that call for substitute performance.

In a construction contract, substitute performance might mean, for instance, using a different method or type of material in the contract. International principles provide that parties should be amenable to this sort of alteration in the interest of efficiency on both sides.

Substitute performance may also take the form of doing someone else's task in the contract. For instance the ORGALIME offers this type of substitute performance in a limited number of cases, e.g. under Sub-Section 15.4 the Contractor may remedy defects not attributable to him and replace any wearing parts at the expense of the Purchaser prior to tests, if the Purchaser fails to do so. Also, if the Contractor fails to remedy a notified defect attributable to him (the Contractor) within grace period, the Purchaser may himself take necessary reasonable measures to remedy it at the Contractor's cost (Sub-Clause 17.14 ORGALIME).

Finally, it is important to note that in some cases, substitute performance is not possible. There are two primary ways that substitute performance can become an issue in cases. First, it may become difficult, impossible, or impractical for a party to perform the contract in the way that was originally suggested. With this, it becomes incumbent on the party to perform in a different way. Also, something may have happened to make it impossible to

procure performance in a way that is convenient for both parties. When this is the case, it is routine for courts to order rescission of the contract. While not ideal because it can cause one party to feel as if they missed out on the benefit of a bargain they made, it is sometimes the only option when the circumstances have evolved in such a way that the contract can no longer be honored.

Nonetheless, note that Specific performance is considered as a prime relief on several occasions. For instance, under the provisions of Sub-Clause 12.3 ORGALIME, if upon joint inspection after Mechanical Completion the Purchaser notifies the Contractor work, which should be additionally performed or corrected, the Contractor should perform under the request, otherwise the expert shall resolve the dispute. In case Completion Tests fail the Contractor should immediately remedy the deviation (Sub-Clause 13.5 ORGALIME); if the Contractor declares himself unable to remedy such deviation, the Purchaser is entitled to the liquidated damages for performance.

## **B. Damages**

In international construction contracts, the most common sort of remedy comes in the form of a financial payout from one party to the next. The breaching party, which bears the responsibility for violating some provision of the contract, will often times be required to make the other party whole, depending on the circumstances<sup>194</sup>.

Damages' claims in construction from the contractor's point of view may refer to delay, disruption, acceleration, differing site conditions, changes in scope, pass-through and termination claims; from the employer's/project owner's perspective claims often relate to liquidated damages, delay damages, defects damages and damages for termination<sup>195</sup>.

The FIDIC's Silver Book, which has become in many ways the gold standard for construction contract issues, provides that whenever there is delay or some other form of

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<sup>194</sup> UNCITRAL Legal Guide, *Drawing up International Contracts for the Construction of Industrial Works*, New York, 1988, p. 226,

<sup>195</sup> Robert F. CUSHMAN Et al., *Proving and Pricing Construction Claims*, Aspen Publishers, 3<sup>rd</sup> Edition, 2001.

breach, parties may be entitled to compensation as a result of that<sup>196</sup>. Generally speaking, this is based on the legal principle that parties should be made whole whenever they have been aggrieved in a contract situation.

Importantly, there are many different losses that can be claimed according to the guidelines. The most common is in the form of lost profits. So long as the profits are foreseeable by the parties that enter into the contract, they can be claimed in a breach of contract action. Lost profits must directly flow from the contract breach in order for them to be ordered according to the FIDIC guidelines. It is generally a fact issue for the jury or arbitrator to consider when trying to come up with the appropriate amount of damages for lost profits. Litigants in a dispute will often times present documentation as to their expected cash flow, their past years' revenue figures, and industry projections. While there is no one established way to show the lost profits that a company has suffered, any of these methods can establish this information, and the goal is often to show the fact finder what has happened to the company. Companies are entitled to recover all such lost profits that they have suffered as a result of the breach of contract that has occurred. This is not the only compensation-related item that a party can recover on, but it is likely the most common in international construction contract disputes<sup>197</sup>.

A series of other direct modes of compensation are available to those who have suffered, according to the FIDIC. Namely, loss of productivity is allowed when there is a breach of contract. Loss of productivity is more difficult to calculate because it is often hard to tell how much the disruption actually caused the business in question to lose. This is why, in most cases, this is packaged together with other damages rather than being a standalone damage. Importantly, one might also look at finance charges and increased preliminaries as a form of compensation a party can seek for breach of contract under these circumstances. Head office overhead costs are also recoverable as a damage according to the guidelines. The job of the lawyers who are reviewing the contracts and who are trying

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<sup>196</sup> Douglas OLES, "Remedies for Nonpayment in Four Standard Construction Contracts", *Constr. Law*. Vol. 16, Iss. 20, 1996, p.23.

<sup>197</sup> Armen A. ALCHIAN and Harold DEMSETZ, Production, Information Costs, and Economic Organization, *American Economic Review*, 1972, Vol. 62, p. 780 .



to claim damages is to come up with a specific number that will be credible in front of either the court in question or the review board, depending on where the dispute is being heard<sup>198</sup>. Because the goal of contracting is to make parties whole, figuring out damages is much less about punishing a party that has breached and much more about actually ensuring that parties are made whole.

Take for instance Sub-Clause 8.9 FIDIC “Consequences of Suspension”, it states that if the Contractor suffers Delay and/or incurs Cost as a result of the Employer’s instruction to suspend the Work, subject to notice on such, the Contractor should be entitled to extension of time and payment of the Cost (unless he contributes to reason for suspension by faulty design and similar); additionally under Sub-Clause 8.10 FIDIC the Contractor should be entitled to payment of the Plant and Materials which are delayed in delivery due to the suspension. If testing is delayed due to the Employer he should compensate the Contractor’s Cost and provide for extension of time if necessary (Sub-Clauses 4.4(5) and 10.3 FIDIC).

Furthermore, pursuant to Sub-Clause 15.4 (c) FIDIC “Payment after Termination”:  
“After a notice of termination [by the Employer], as a result of the Contractor’s breach, the Employer may recover from the Contractor any losses and damages incurred by the Employer and any extra costs of completing the Works. Where termination is upon optional termination by the Employer, then pursuant to Sub-Clause 19.6 FIDIC, the Employer should pay to the Contractor for the performed works, ordered materials and works, other related reasonable costs, removal of the Temporary Works and Equipment, repatriation of the stuff employed specifically for the purpose of the Works). Also, as is embodied in Sub-Clause 16.4 (c) where the contractor terminates the contract as a result of the Employer’s breach, the contractor is entitled to receive from the employer the amount of any loss of profit or other loss or damage sustained by the Contractor as a result of this termination.

ORGALIME, on the other hand refers to damages’ compensation in the following situations. Pursuant to Sub-Clauses 6.5, 7.6 and 10.3 ORGALIME the Contractor should,

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<sup>198</sup> Armen A. ALCHIAN and Harold DEMSETZ, Ibid, p. 781.

In a number of cases, be compensated for additional cost and expense resulted from the delay, suspension or variation due to the Employer, and also from Force-Majeure or the Employer's Risk events. The Contractor should also be liable for all defects due to incorrect design under Sub-Clause 17.7 ORGALIME (unless they are attributable to the Purchaser's request).

According to Sub-Clause 20.2 the Contractor should be liable for and should make good any damage to the Works prior to taking-over, unless it is caused by the Purchaser's negligence or any of the Purchaser's Risk events. Under Sub-Clause 20.4, the Contractor shall be liable for damage to the Purchaser's other property than the Works when such damage is caused by the Contractor's negligence"<sup>199</sup>.

Damages concept is further provided for in the event of breach of confidentiality obligations, as is embodied under various Clauses in the ORGALIME, to the effect that a party who is in breach of such confidentiality terms shall compensate the other party for the damage caused by such breach.

In case the contract is terminated due to either party's default, similarly to FIDIC, Clauses 19.5 and 19.8 ORGALIME stipulate that the injured party is entitled to compensation for the loss she suffered. In case of contract termination by the Purchaser/Employer under its own option, i.e. when there is no breach on the part of the Contractor, then he shall compensate to the Contractor under Sub-Clause 18.3 ORGALIME: i) unpaid balance for the performed part of the Works; ii) all costs for the material purchase prior to the termination notice; iii) all reasonable costs and charges incurred by the Contractor due to termination; iv) other direct expenses of the Contractor and his sub-contractors related to the termination.

It is important to note that compensation is generally the default when it comes to this kind of breach of contract. In construction contracts, there are often other remedies, but when it is difficult to come up with a more specific remedy, money damages will need to

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<sup>199</sup> Sub-Clause 20.5 ORGALIME refers to an equal liability of the Purchaser in case of damage cause by its negligence.

suffice. Just as common law contract doctrine and the UCC provide for different kinds of compensation damages, international law on construction contracts does the same. Namely, compensation can be based on various theories of recovery. Expectation damages would cover things like lost profits, as mentioned above. This means that the party suffering from the breach would be given damages such that they would be put in the position that would have been expected if they did not suffer from the breach. Consequential damages would be another category. This means any damages that a company suffered as a result of the breach. For instance, in a construction contract, if some delay in construction required a party to have to purchase additional and otherwise unneeded services in order to function properly or serve customers, then this would be a consequential damage—or a “consequence” of the breach—and it would be possible for the company to recover.

All discussed above pros and cons of the damages remedy are relevant when it comes to the construction contract claims. As a general rule damages for the breach of contract can be awarded only if they represent actual loss suffered by the aggrieved party and would place her in the same position as if the contract was not breached, otherwise specific performance is a more befitting remedy, then that is likely the remedy that shall be awarded.

### **C. Termination**

When looking at remedies in the construction contract context, there are varying levels of remedies that can be utilized by the parties to the agreement. Some of them, of course, are smaller and less consequential. The FIDIC rules allow for there to be price adjustments, as mentioned, in the interest of equity and fairness. The FIDIC rules also allow for there to be some withholding for delay and the like. However, some of the options on remedies in the construction contract context are much more nuclear in nature. They go to the entire root of the entire agreement extinguishing it, and allowing parties to get out of their obligations and move on down the road. This is not the preferred way of handling these problems, of course. When parties have gotten this far down the road in a contract situation, they have already likely put other opportunities on hold. They have

invested money and time, and they have made plans according to whatever has been going on in the contract. This means that terminating the agreement will in many ways hurt both the contractor and the employer such that both parties have a great interest in figuring out a way through the issue without having to resort to termination. However, as parties to these deals can always attest, despite the best laid plans of those involved and the comprehensive efforts to avoid this kind of consequence, it is often the case that the sides will not be able to fix their problems and will thus be required to simply walk away from the agreement rather than coming up with some kind of grand bargain to fix it.

Nonetheless, they are times when termination of the contract is really the best alternative to do, in the event of breach. Nonetheless, because of the sensitivity of this sanction, there are certain rules that end up governing the termination of contracts. It is not just something that a party can do because they are displeased with some small thing that has taken place. Instead, the process is more difficult and involved than this, and for good reason.

The international standards of construction allow for termination as a sanction. The circumstances under which the employer is entitled to terminate the contract are many. They can terminate if there is a failure to pass an inspection. Likewise, if a contractor has been given notice of defects and fails or refuses to remedy them, then there can be termination. On top of that, there are situations where the employer may be able to terminate because of some act of God or something outside of the control of the parties that makes performance of the contract either impossible or not practical. Further, an employer is entitled to terminate the agreement in a circumstance where the contractor has failed to provide adequate security for performance. This is a critical part of the process. On top of that, if there is abandonment on the part of the contractor or if the contractor fails to perform in accordance with standards, then termination is appropriate. In some instances, an undue delay can lead to termination if there is no other option at play. Likewise, the FIDIC rules and regulations provide wide leeway for the employer to terminate the project in case the contractor assigns the contract without getting the necessary agreement. Simply put, if an employer contracts with a contractor to do a job and the contractor simply gives

the deal to another without first getting the consent of the employer, then this constitutes a move for which termination is an appropriate remedy.

Particularly, Sub-Clause 11.4 (2b) FIDIC stipulates that in the event a Contractor fails to remedy defect causing it to be repaired by a third party at Contractor's cost and the defect or damage substantially deprives the Employer of the whole benefit of the Works or their major part, the Employer may choose to terminate the Contract as a whole or in respect of the defective part and without prejudice to any other rights, the Employer is entitled to recover all sums paid for such Works or the respective part, as well as financing costs and cost of the dismantling defective Works (restitution). Furthermore, in addition to an Employer's right to terminate a contract for his own convenience, Sub-Clause 15.2 FIDIC stipulates that the Employer is also entitled to terminate the contract i.e. in case the Contractor fails to perform its particular obligations and rectify defects within proposed time, assigns the agreement in avoidance of prohibition, becomes bankrupt or insolvent, or goes into liquidation.

The contractor is also entitled to terminate the contract in case the Employer fails to fulfill his particular obligations, to rectify the breach in additional time, or substantially breaches his obligations, breaches the assignment order, keeps the unreasonable suspension, becomes bankrupt or insolvent, or goes into liquidation (Sub-Clause 16.2 FIDIC). Upon such termination the Employer has to pay to the Contractor outstanding balance, compensation of incurred costs, removal costs, some labor costs, and also – loss of profit or other loss/ damage resulting from the termination (Sub-Clauses 16.4, 19.6 FIDIC).

The ORGALIME also provides for termination. Pursuant to Sub-Clause 17.14 ORGALIME, The Purchaser may terminate the contract if the Contractor failed to remedy substantial defects. In accordance with Clause 18 ORGALIME the Purchaser is entitled to terminate the contract for his convenience and in the event he does so, then he should pay to the Contractor unpaid balance for the performed works, some costs, termination charges (LD/penalties), removal costs (Sub-Clauses 18.3, 18.4, 18.7 ORGALIME). Similarly, ORGALIME provides that the Purchaser is also entitled to terminate the contract in case of

the Contractor's and Contractor's insolvency. In this case the Purchaser is entitled to compensation of suffered loss (not more than 15% of the contract price) and in addition – liquidated damages (Sub-Clause 19.5 ORGALIME), minus the Contractor's compensation for the completed part of the Works without defects (Sub-Clause 19.9 ORGALIME).

Also, where the Project owner temporarily suspends the contract, ORGALIME stipulates that the Contractor may terminate the Contract in the event this voluntary suspension exceeds 180 days subject to 14-days'-period notice. The Contractor is additionally entitled to initiate termination in case of the Purchaser's breach of the payment terms and failure to remedy it within stated period of time (Sub-Clause 19.6 ORGALIME) and in case of Purchaser's insolvency (Sub-Clause 19.7 ORGALIME). In these cases, the Contractor is entitled to receive compensation for the suffered loss, not exceeding the Contract Price (Sub-Clause 19.8 ORGALIME).

Further, both the FIDIC Yellow Book (M&E, building and engineering works designed by the Contractor) and the FIDIC Red Book (building and engineering works designed by the Employer) provide guidelines on when and how termination must take place<sup>200</sup>. Termination requires that the employer provide notice to the contractor before termination can take place, and there will be a review board that will look at things if the contractor ever happens to file a challenge to the termination. If that challenge takes place and the review board decides that the termination was done without cause and in error, it can cause financial consequences for the employer and can cost them financially. This is why, when it comes to termination, many employers take things very seriously in their review process. The stakes become quite high according to international standards, so it must be done right and only when cause is present.

When looking at termination, one must note that it is always possible for sides to negotiate for termination procedures that are different than those that might normally be available under the law. For instance, under the governing law of wherever the contract was

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<sup>200</sup> Jeremy GLOVER and Simon HUGHES, *Understanding the FIDIC Red Book: A Clause by Clause Commentary*, Sweet & Maxwell Publishers, 2011, p.28.

made, it might be possible for a party to terminate the agreement upon the missing of a payment deadline by the employer. However, whenever the parties enter into their deal, they can actually put their own rules into place that can do away with this and narrow it altogether. The contract can state that termination can only take place in certain contexts, thus taking away the remedies at law that might have been there without the private law of contract being the governing force. In short, the rule put forward by the contract can limit or do away with the potential remedies that would have existed purely at law, but the law itself cannot, in almost every instance, limit what the parties are allowed to contract to. The general rules of contracting still apply, as parties are largely free to agree to whatever they want, at least within reason.

There are some distinctions on who can terminate. According to the FIDIC rules, there is a bargaining imbalance on these contracts when it comes to the right to terminate. Both the employer and the contractor have rights to termination for various causes. The difference, of course, is that the employer has a right to terminate for convenience if certain conditions are met. The contractor has no such right to terminate for the sake of convenience. This is an important difference between the options available to the two different sides, and it means that on the balance of things, the employer tends to be in a much stronger position when the rules of the Red Book and Yellow Book of FIDIC actually apply<sup>201</sup>. With that said, it is not all arbitrary for the employer, and the guidelines must still be followed to some extent.

Finally, in cases where there is some illegality, such as when a contractor attempts a bribe or breaks one of the relevant laws, putting the employer in danger, the employer is not required to work within that relationship any longer.

On the question of termination for reasons of convenience, there are other justifications and also different practices that are put into place. Namely, an employer looking to avail itself of this type of remedy would need to pay for the performance that the

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<sup>201</sup> Brian W. TOTTERDILL, *FIDIC users' guide: a practical guide to the 1999 Red and Yellow Books*, Thomas Telford Publishers, 2006, p.87.

contractor has already undertaken<sup>202</sup>. It is not allowed to have a company simply cut off an agreement for convenience and then take advantage of the contractor. The law does allow for termination for this reason, but it also puts on the employer an obligation to pay for the value that it has received as a direct result of this, making it at least somewhat fair and reasonable for the contracting parties that have to go through it.

FIDIC matches the civil code in several countries, including the US and the UAE, when it comes to what contractors can do in terms of termination. Simply put, the law does not seek to impose restrictions or conditions that would require contractors to carry on with their work whenever the employer at the heart of the deal has gone insolvent or has refused to pay for the work. The process and procedure through which the contractor must choose to terminate the deal is somewhat complex. It is not possible to just terminate the contract on the first glance whenever financial problems have arisen. The proper way to proceed is to first suspend work and withhold performance, giving the employer notice of what has taken place so that they may, ideally, remedy the problem and provide payment. However, after withholding performance and suspending work on a project, if the employer still does not undertake to pay, or if it becomes clear that the employer is not going to have the ability to pay out under the agreement, then it may be possible for the contractor to terminate the agreement and sue for damages. The contractor in this instance is entitled to the value of the work that he or she has done, or for expectation damages. The damage remedy will be largely based on the situation. However, it can be difficult to recover in this instance because of the nature of the agreement. Namely, if a party has become insolvent and this is the reason for the termination, then being able to recover damages in a lawsuit is unlikely because the employer may not have the money to make it happen. This is why the law and the FIDIC regulations do not require the contractor to continue to push forward and perform work when it is not likely that the contractor will ever be paid for the work in the future.

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<sup>202</sup> TOTTERDILL, *Ibid*, p.88.



## **D. Price Adjustment**

Price adjustments could reasonably be looked upon as a sort of sanction that is designed to keep things moving so that deals do not have to totally fall apart. Whenever one is dealing with construction contracts, one is usually dealing with long time frames and big investments from a financial perspective on the part of all parties. This means that if a deal happens to fall through entirely, it hurts almost everyone, and starting over can be the worst possible thing that the parties to a contract can do. With this in mind, what should be done whenever there is a small problem that does not destroy the deal but does make the deal weaker? The answer is somewhat easy to understand. Namely, when this happens, it is sometimes possible for the court to order a price adjustment. To imagine how this might happen in the context of a construction contract, one can look at any number of examples. For instance, if it is found that a contracting company did not use the proper materials, then the price could be reduced to reflect the lower quality of the items. Importantly, one could also adjust the price to reflect the problems that are faced with delays in construction. This is an equitable remedy that will sometimes be agreed to by the parties so that they do not have to waste their money with expensive litigation. It can also be something that the court orders because it feels that it is not appropriate to make one party pay the full contract price when it has not received the full benefit of its bargain. This is most often used in a situation where there is a breach that is less than material; it matters, but it does not matter enough to totally tank the deal<sup>203</sup>.

Price adjustment is embodied under Sub-Clause 9.4 FIDIC, it states that in case the Works or Section fail to pass the Tests on Completion repeatedly, the Employer may on issuing the taking over certificate, reduce the contract price by the amount corresponding to the reduced value as result of the failure. Also, the concept of price reduction is further empahsized under Sub-Clause 11.4 FIDIC, which stipulates that In the event the Contractor fails to remedy notified defect or damage by the set date and the work is to be executed at

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<sup>203</sup> UNCITRAL Legal Guide, *ibid*, p. 200.

the cost of the Contractor, the Employer may agree or determine a reasonable price reduction in the Contract Price.

Similarly, under Sub-Clause 17.14 ORGALIME, if the Contractor fails to remedy remaining defect and the Purchaser chooses not to repair it at the Contractor's costs or the defect persists after such repair, the Purchaser may demand price reduction corresponding to the reduction in value of the Works due to the defect, but not more than aggregate of 15% from the Contract Price.

Also, another way in which price adjustments are used in construction contracts has to do with the volatility and variability of pricing. Namely, commodities and labor may seem certain in their pricing, but as any contractor will attest, there is tremendous uncertainty in what it will eventually cost to actually procure the goods or the labor. With this in mind, there are allowances that provide options for those who contract to make price adjustments when the market is uncertain. International construction contracting guidelines allow for there to be some variability there so that a contractor is able to increase the price whenever it is impossible for him to procure parts or labor at a certain, expected price. Courts in various countries have been willing to accept these kinds of clauses on one specific condition. Namely, it is necessary that there be a fair two-way arrangement on price adjustments. The price can be adjusted up if the expected prices for the necessary goods and materials go up during the course of the fulfillment of the agreement.

Price increase is generally usually considered in case of variation or suspension of works due to the Employer; but there are other reasons for increase as well, i.e. where there is suspension/interruption in the performance, requested by the Employer.

Under Sub-Clauses 8.9 (1 b), 8.10 FIDIC and Sub-Clause 16.1 (4 b) FIDIC, in case of suspension the Contractor is entitled to be paid value of the Plant and Material suspended in delivery for more than 28 days, other related costs and reasonable profit, which should be added to the Contract Price. Also, if the Employer hinders performance of the Completion Tests more than 14 days the Contractor is entitled to the payment of the related costs plus reasonable profit, which should be added to the price subject to respective

notice to the Employer (Sub-Clause 10.3 (2b) FIDIC). According to Sub-Clause 12.4 (3) FIDIC if the Employer hinders Contractor's access to the site in order to investigate tests' failure or carry out modifications, the Contractor should be entitled to the related costs and reasonable profit, added to the Contract Price (subject to notice).

The ORGALIME also calls for price adjustments in the event of suspensions, pursuant to Sub-Clause 10.3 ORGALIME in case of voluntary suspension the Purchaser should compensate to the Contractor "all necessary expenses arising from: a) de- and remobilization of the personnel and equipment; b) safeguarding the Works and ...related items; c) personnel, subcontractors, equipment kept available; d) moving the Works; d) other expenses...as a result of suspension".

Finally, there must also be allowances made for situations in which the price is cheaper. If a contractor makes an agreement and is later able to procure goods and labor for a cheaper price, then a price adjustment downward is appropriate. Again, one of the fundamental dynamics in this regard has to do with the need for the two sides to have somewhat equal bargaining power whenever making the deal. So long as the sides are at arms length and each has an equal bargaining leverage, then courts will be more likely to allow parties to a construction contract to simply make an agreement that they want.

## **E. Withholding Performance**

Often times, in the course of a construction contract situation, one party will fail to live up to its obligations, triggering the possibility of the other side tapping into sanctions. While the result is sometimes to sue for damages or specific performance, the remedy in some instances can simply be to withhold performance<sup>204</sup>. It is easy to understand why this may be the case. Namely, if a party is not paid for the work that they have done, then the party is not obligated to perform. Likewise, the law allows for the withholding of performance in part as an incentive to the other party to pay. When a contracting party to a

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<sup>204</sup> Marthinus Johannes MARITZ, and Dirk Cornelius ROBERTSON, "What are the legal remedies available to contractors and consultants to enforce payment?", *Journal of the South African Institution of Civil Engineering* , Vol. 54, Iss. 2, 2012, pp 27-35, p.32.

construction deal is not paid, withholding performance will often cause the other party to actually step up to the table and fulfill its obligations so that the project can continue to go on as planned. Because delays in construction can cause companies to lose significant amounts of revenue and productivity, no party wants the other to withhold performance. This means they are incentivized to actually pay up<sup>205</sup>.

Another common situation, which is outlined in the FIDIC guidelines, has to do with performance bonds that are paid out to contractors. Whenever deals are struck in the construction context, employers often ask contractors to put up a performance bond. The reason for this is somewhat simple, and is because Construction contracts are usually very complex and expensive and lawsuit's may not always be the easiest, cheapest or assured way to recover in the event there is a breach of contract. Practically looking at a situation, the most common reason why a contractor would end up breaching the deal, either through non-performance, delay, or some other mechanism, is because that contractor is suffering from business or economic problems. This is a major worry for employers because they know that if a contractor fails to perform under the deal and is also suffering from its own economic problems, then it will be all but impossible for the employer to sue and collect, even when he is successful in court. As such, even when the court orders compensation, it does not always work or help because the party may have become bankrupt, insolvent. What is the solution, then? Generally speaking, it involves requiring the contractor to post a performance bond. That bond guarantees performance, and if the contractor fails to actually live up to the deal, then the employer can call in the bond, cashing it in. This makes it easier to get the remedy because the money is already provided, so the employer in the contract will not then have to go through with a full-on lawsuit. Critically, this is also seen as a due diligence and insurance mechanism. If a contractor is not able or willing to put up a performance bond, then it is a real red flag for the employing company, which may then look at the contractor as not being real or legitimate. At the end of the day, when a performance bond is required, it serves multiple purposes that allow for the employing

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<sup>205</sup> MARÍTZ and ROBERTSON, *Ibid.* p.33.

company to actually rest easy in knowing that it is going to get the full benefit of whatever deal it happens to have struck.

With this in mind, there is a two-way exchange when it comes to withholding performance. The first of this exchange has to do with withholding performance on the part of the contractor. The contractor is entitled, under FIDIC and other international contracting guidelines, to not perform if they are not paid for their services. This rule becomes important because of the way in which many of these contracts tend to be structured. Namely, there are often payments made according to a suitable schedule as the project goes on. Employers are required to pay something up front, then meet payment promises and deadlines along the way. When they fail to do so, the law allows that the contractor does not have to actually perform until they are paid. This helps to protect the contractor from putting out work and then having to file an expensive lawsuit to recover damages from an employer that is not willing to deal fairly. However, on the flip side, there can be a withholding of the performance bond in response to something done by the contractor. Namely, under every contract, there is an obligation for the employing company to actually give back the performance bond whenever the work has been done fully, properly, and on time. Generally speaking, there is a requirement that it be done quickly, as well, because the contractor may have laid out a lot of money in response. Withholding performance in the context of the bond means that the employing company simply holds that money and refuses to pay it out until something is done to ensure that the contracting company is living up to its end of the deal. This is different, of course, from the employing company actually cashing in on the bond because of the non-performance. This is just a similar remedy to the contractor withholding performance in order to induce payment. The employing company's refusal to give back the bond will be designed to induce performance on the part of the contractor just the same.

Apart from Performance bond, Sub-Clause 15.4 (b) FIDIC stipulates that where there is a termination, the Employer may withhold payment to the Contractor until establishment of all costs incurred by the Employer. Additionally, FIDIC provides for the instrument of "Retention money", which can be withheld by the Employer and released

upon due performance (Sub-Clauses 1.1.4.7, 14.3(2(c)) and 14.9 FIDIC). The contractor, under Sub-Clause 16.1 FIDIC, also has a right to withhold performance. It is stated that when the Employer fails to perform the Contractor may suspend performance subject to 21-days'-notice until the payment without prejudice to the interest for the late payment.

Pursuant to Sub-Clause 9.4 ORGALIME the Contractor is entitled to suspend performance upon 7-days'-notice, if the Purchaser fails to pay on time, until payment of the amount due and interest. According to Sub-Clause 9.5 ORGALIME the Purchaser is entitled to withhold part of the payment upon taking over for securing remedy of the defects appeared at taking over until completion of such remedy. Upon termination for his convenience the Employer may deduct from termination fee amount of his claims notified to the Contractor prior to termination (Sub-Clause 18.4(2) ORGALIME).

## **F. Penalty Provisions**

The general rule in contract law is that courts disfavor penalty provisions. Contracts themselves are meant to be financial instruments. They are meant to facilitate deals. There is some understanding that parties will occasionally breach contracts. On top of that, there is an understanding that many times, it will make sense to breach an agreement because it is more efficient to do so. With this in mind, the general preference in international contracts on construction is to disfavor penalty provisions because they go outside of the purpose of contract remedies in many cases. They tend to want to enforce some kind of moral incentive for performance rather than doing what remedies normally do—putting the party that has suffered the breach in a position to be successful.

The way penalty clauses work is somewhat simple. The clause in the contract will outline what happens if a party happens to do something or not do something. If it does something it should not do or if it happens to miss out on one of its obligations, then the penalty is there to provide the other side with some compensation. The goal of penalty

clauses is two-fold—to provide compensation on one end but also to provide a disincentive to breach on the other end<sup>206</sup>.

An example of penalty comes in the form of interest for the late payment as stated in the Sub-Clause 14.8 FIDIC (called “financing charges”); Sub-Clause 9.3 ORGALIME calls it the late payment interest.

In case of delay, FIDIC and ORGALIME provide for the liquidated damages, therefore these two standards do not use term penalty and do not distinguish between penalty and LD.

Where penalty clauses run into problems in various courts around the world has to do with the amount. Penalty clauses must on some level reflect the actual damage that a party has suffered as a result of the breach. At the very least, it has to be a reflection of the expectation of damages that might be suffered in a situation that is similar to the one in which the breach took place. Importantly, the penalty clause sections of construction contracts can often overstate the damages suffered, which means they will be subjected to some analysis on the part of courts. While different courts in different jurisdictions have their own rules on these matters, one of the most important rules is that, if there is no rational relationship between the penalty and the damage that was caused by the penalty, the court has the discretion to reduce the penalty amount to a more appropriate figure. Often times, in order to dissuade companies from putting in penalty provisions that are overly onerous, courts will reduce these clauses all the way down to \$1 to send a message that the point of contracting is not for one party to set up the other in a situation where the party that suffers the breach will end up with a windfall.

There is, however, a preference among courts for allowing parties to contract in the way they choose. These two public policy ideas often clash with one another when it comes to penalty provisions. A penalty provision that is over board or too high is negative, while the idea of disrupting an agreement between parties is also a negative. One of the things the

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<sup>206</sup> UNCITRAL Legal Guide, *ibid*, p. 219

court will look at is whether or not the parties had equal bargaining power. Whenever the penalty provision is enforced against a smaller, less financially equipped defendant, it will be enforced less often. When the parties have somewhat equal bargaining power, it will be much more likely to be enforced. In construction contracts, where the parties are usually fairly equal in their bargaining power, penalty clauses are more likely to be actually left alone by the courts, assuming they are not too outrageous<sup>207</sup>.

## **G. Liquidated Damages and Limitation of Liability**

Close and similar to a penalty clause is a liquidated damages clause. The point of a liquidated damages clause is to provide for damages when the amount may be uncertain. In some cases, it is going to be difficult to figure out just how much an error will cost a company. For instance, it would be difficult to know how much money a hospital lost because of a delay in building one of its new wings. There are simply too many factors in that to be able to make a fair determination. This becomes a problem when one tries to come up with a solution later that can make parties whole in case of a breach. With this in mind, the idea is to have a liquidated damages provision that can provide options on the back end so that the parties have a reasonable expectation of what to expect. Because one of the points of a contract is to clarify the relationship between the two parties and the working agreement that they have with one another, it is important that this clause be clear. For instance, it may provide that in the case of a delay, the party responsible for the delay will owe \$500 per day in liquidated damages. This would then allow the sides to prepare and to make choices about what does and does not work for them<sup>208</sup>.

Pursuant to Sub-Clause 8.7 FIDIC the Contractor in delay should pay delay damages (“sum, stated in the Particular Conditions”), calculated for each day of default at the stipulated in the contract rate, however, the total amount of which should be limited to a stipulated maximum; these damages should be exclusive remedy for this type of default

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<sup>207</sup> UNCITRAL Legal Guide, Ibid, p. 220.

<sup>208</sup> Kimberley EYSSELL, *Concurrent Delay*, 2010, D.A 26.5.2019, [http://www.charlesrussell.co.uk/UserFiles/file/pdf/Construction%20&%20Engineering/BB\\_sept\\_2010/concurrent\\_delay.pdf](http://www.charlesrussell.co.uk/UserFiles/file/pdf/Construction%20&%20Engineering/BB_sept_2010/concurrent_delay.pdf);



and keep the contract and obligations intact. Sub-Clause 12.4 FIDIC “Failure to Pass Tests after Completion” provides for possibility to recover damages for non-performance (“sum is stated in the contract or its method of calculation is defined”), which may be defined as liquidated damages, but the Contractor first should provide for the adjustments and modifications of the works, attempting to rectify non-performance. Total liability should be limited to the sum stipulated in the Particular Conditions (Sub-Clause 17.6 FIDIC).

The ORGALIME too, under Sub-Clauses 16.1 and 16.2 respectively, explicitly refers to Liquidated Damages for Delay and Liquidated Damages for Performance; Sub-Clause 16.3 ORGALIME limits the Aggregate Liquidated Damages. Accordingly in case the Works do not fulfill the performance undertaking, requirements for testing or guarantee specified in the Contract and the Contractor declares himself unable to remedy the deviation (Sub-Clauses 13.5, 15.8, 16.2 ORGALIME) the Purchaser is entitled to LD, with limitation of Performance Liquidated Damages to 5 % of the contract price (Sub-Clause 16.3 ORGALIME). So called “termination fee” stipulated in case of the contract termination “for the Purchaser’s convenience”, in my opinion, can be treated as LD or a penalty: 4% of the Contract Price or 6% of the unpaid part of the Contract Price (Sub-Clause 18.4 ORGALIME).

As one might suspect, many of the concerns that are present with penalty clauses are also present with liquidated damages clauses. Generally speaking, the liquidated damages clause is more accepted than the straight penalty provision because there is some logical relationship between these damages and the actual damages suffered. In order for these remedies to be enforced and ordered by the court, there needs to be some calculation based upon the expectation of the party at the time of the execution of the contract. For instance, in the case of a construction contract, the company that is looking to have something built would need to base its liquidated damages provision on the projections that it has for its revenue at the time that it enters into the agreement. This is done to make sure

that the parties all have the same expectations and that things do not change during the middle of the deal<sup>209</sup>.

There is a close cousin to the liquidated damages clause that is called the limitation of liability clause. The limitation of liability clause is something that limits the amount of liability one side may have in the case of a lawsuit. For instance, in a construction contract, it may say that in the case of any lawsuit, one party is only responsible up to \$1 million in damages. This gets important because it can allow smaller companies to work on big projects without having to worry that they are going to be blown out of the water in some way. However, it is also true that these limitations of liability can, in some cases, go against public policy. American courts have been increasingly invalidating these clauses because they do not believe that parties should be able to limit their liability for all types of claims that may arise out of the contracted relationship. However, so long as the limitation is in regard to direct compensatory damages on the contract, the two sides are usually allowed to make a deal for whatever they want. This goes along with the previously explained concept that courts will look, whenever possible, to not rock the boat while allowing people to generally enter into the deals that they are looking for<sup>210</sup>.

Limitation of liability (LL) is implemented in Sub-Clause 17.1 (b) FIDIC “Indemnities”. It stipulates that the Contractor shall indemnify and hold harmless the Employer against all claims, damages, losses and expenses (including legal fees and expenses) in respect of: damage to or loss of any property, real or personal (other than Works), to the extent that such damage or loss: (i) arises out of or in the course of or by reason of the design, execution and completion of the Works and the remedying of any defects, and (ii) is not attributable to any negligence, willful act or breach of the Contract by the Employer. Furthermore, Sub-Clause 17.6 FIDIC on Limitation of Liability categorically states that both parties shall not be liable to each other for loss of use of any Works, loss of profit, loss of any contract or for any indirect or consequential loss or

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<sup>209</sup> PIECK, *ibid*, p.134 .

<sup>210</sup> PIECK, *ibid*, p.134.

damage which may be suffered by the other Party in connection with the Contract, other than under [Payment on Termination] and [Indemnities clauses].

Additionally, scope and/or duration of liability is usually regulated by the provisions related to the warranty period. Sub-Clause 1.1.3.7 FIDIC states that the Defects Notification Period, where a contractor continues to be liable to the employer after handing over the project, should by default, be limited to one year, unless Particular Conditions provide otherwise. Although FIDIC allows for extension of this period where the contractor continues to be liable for defects, Sub Clause 11.3 FIDIC states that this period may be extended for the period when the Work or any Section of it may not be used due to defects, but not longer than for two years.

The ORGALIME, through Sub-Clause 16.5, also limits the right of the Purchaser to collect Liquidated Damages not only by amount, but also by introducing limited period for the claim – 180 days from the prescribed date. Further, according to Sub-Clause 17.2 ORGALIME the Contractor's liability should only cover defects, which appear within the warranty period, which may be extended not more than for one more year (Sub-Clause 17.4 ORGALIME). Additionally, pursuant to Clause 17.5 ORGALIME the Contractor is exempt from liability for defects caused by number of circumstances arising after taking over, such as improper operating conditions, incorrect maintenance etc. Sub-Clause 17.10 ORGALIME even provides the possibility for sharing expenses for remedying the defects between both parties.

Clause 25 ORGALIME "Limitation of Liability" further states that neither party shall, except as specified in the Contract, whether in contract, tort (including negligence) or otherwise, be liable for or obliged to indemnify the other party for any direct or indirect loss or damage such as, but not limited to, loss of profit, loss of use or production, loss of data and loss of contracts. This limitation of liability shall not apply, however, where such loss or damage has been caused by willful misconduct or gross negligence.

#### **IV. INTERMEDIATE CONCLUSIONS**

In looking at the international construction contract remedies, it is clear that various bits of civil law in various countries, and the standards on which all parties rely in the international context, have some overlap. This is because the general principles are common sense and have been hammered out over time as parties have figured out what the problems will be in their deals and what some of the best ways of dealing with those problems will happen to be. In light of this, one can see that there are certain themes that emerge.

Namely, the remedies are designed to be two-sided, though this is not always the case. Generally speaking, because a contract is a deal full of promises made between parties on either side of the line, there is an expectation that both sides will play fair and live up to their obligations. When that does not happen, it should be expected that both sides would be able to sue on the contract in order to get recompense for whatever problem has taken place. However, as one can see with the FIDIC Yellow and Red books, employers often have much more power and leeway when it comes to the resolution of problems and with protecting themselves from breach. The ability to have a bond to guarantee performance, for instance, is a huge help and can also be a big burden on the contracting companies. It can make it hard or even impossible for a small company to compete with the big ones whenever the small company has to put up some of its capital to ensure performance. Likewise, because the FIDIC regulations provide that an employer can terminate for convenience while this remedy is not available to the contractor, one can see that it is often true that both sides do not have a fair shake when it finally comes down to it.

Likewise, one can see that the rules on remedies are often meant to allow parties to work things out first before it ever gets to the point where one side is going to terminate the agreement. The reason for this is all economic. Parties will often extend resources and burn opportunity costs whenever they are trying to deal with another company. This often happens up front, with most of the investments coming then but many of the benefits actually coming on the back end of the deal. This means there is a huge incentive, once the

contract has been put in place, for the two sides to find a way to make the deal actually work. They do not want to have to terminate the deal and expend resources in litigation. This both costs them money *and* requires them, to some extent, to lose their opportunities that would have come with the successful completion of a project on time. This is why it is possible to do price adjustments, to withholding performance, and even to have compensatory damages on the contract. Many contractors and employers alike would rather have a project finished and then fight over some of the damages from delay versus having the deal fall through and a new deal with a new company be struck.

Likewise, one can see from the wide range of remedies that there is some preference for solutions in equity. Courts in most countries where disputes are resolved will, on some level, be able to resolve things according to what is actually best for the parties rather than having to resolve every dispute with money. One might look, for instance, at some of the provisions on substitute performance and specific performance to see that the rules and regulations are more common sense than they may have seemed at the beginning. Often, in the context of construction contracts, it is critical to order specific performance because parties tend to have so few deals that they actually enter into. Contractors will often have one or two big deals going on at any one time, depending on the size of their operation. This means that every single deal is critical to them in some way. This is different from contracting merchants who may have many deals going on at any given time, so each individual one is not as important to them. Thus, ordering specific performance and requiring parties to follow through on the deal may be the fairest thing for those parties. Fortunately, because courts have such broad power and leeway to make these kinds of determinations, it becomes much easier to ensure that at the end of the day, the parties believe they have been treated fairly.

Ultimately construction contracts provide for a wider array of damage calculations than one might see in other types of contracts. The parties to these contracts are not just dealing with their own remedies at law, either. They are also dealing with the realities of international regulations that govern the craft. This can make things somewhat complex, depending on which body is actually the one governing the given contract. Often times,

figuring out what the remedy will be, will depend heavily on which governing body is actually providing the rules and regulations. Fortunately, many of the places where big deals are being made and completed have somewhat similar principles on this, and the general rules put forward by the international governing bodies have come to reflect this. They have in some ways ensured fundamental fairness and a level playing field, too.

## CONCLUSION

Simply speaking, the main motivation to enter an agreement is the commercial assumption that the outcome of such arrangement is mutually beneficial for the parties. Nonetheless, the truth is that circumstances in the course of the contractual relationship tend to change and get complicated, especially in the international environment such as transnational construction projects, which often involve many actors from different industries and jurisdictions. As such, the breach of a contract is inevitable reality of the market economy and contracting parties should be prepared to face it and deal with it.

Sometimes, the parties to a contract are able to conclude an efficient contract that provides for efficient behavior or procedures that are to follow in the event of a breach of contract. However quite often, due to various reasons such as lack of information, parties do not provide for the sanctions in their own agreements or sometimes due to unequal bargaining positions of the parties, they may provide in their contracts inefficient, unjust and inadequate measures. The laws then are then forced to step in.

All existing differences and conflicts between the main principles of contract law in Civil and Common law systems derive from reviewed specifics of the historical development of academic thought and legal practice and emphasis on factors such as moral and economic considerations, that affected shaping of each legal order.

In this study I attempted to approach contractual sanctions as a system of checks and balances, enforcing simultaneously all principles in respective proportions and ensuring final social good in comparatively more economically efficient legal form.

Sanctions constitute an important element of each contract. They have various functions, with some securing the contract where appropriate, and others aiming to end the entire obligations. Nonetheless, sanctions should generally aim to create flexible system which may adjust to changes in circumstances and serve parties in case the obligation needs modification or termination in perspective.

This study is dedicated to the following remedies currently available under an international contract: specific performance; damages' compensation; termination of contract; liquidated damages and penalty; price reduction and performance withholding. International contract law offers wider variety of more diversified and detailed options, but essentially they all derive from the described types.

All reviewed jurisdictions ensure possibility to claim specific performance under certain conditions as well as Damages. While most jurisdictions consider damages as an alternative remedy, it is actually the generally preferred sanction in Common law. Specific performance has obvious advantages: it secures entity of contract, serves economic principle of indifference, implements original bargain and stimulates information exchange. Nevertheless it also has drawbacks, creating legal uncertainty, tolerating misuse of right and precluding efficient breach.

Termination is criticized for hindering stability of contract, moral hazard, and risk of opportunism. In order to enhance its efficiency it should be restricted to the cases of fundamental breach, and it is advisable that the events that amount to fundamental breach be clarified in the contract between the parties for avoidance of misinterpretations.

Damages are always secured by law as default remedy. While in all cases aggrieved party has to prove sustained loss in order to get award of damages, which brings notion of actual loss close to reliance, some jurisdictions and international codifications allow recovery of lost profit and future losses and that brings notion of expectation close with expectation loss. General duty of mitigation has penetrated Civil law irrespective of explicit absence in the statutory laws.

Although practice indicates that best way of elimination of flaws and pitfalls in application of this remedy may be achieved through the tailored contract terms such as LD clauses. Transactional and legal costs upon breach in case of default statutory damages' rules given uncertainty of judiciary discretion.



Both penalty and LD are pre-determined at contract formation sums, excluding the need to establish actual loss, to be paid only in case of non-excusable breach of the main obligation; stimulate performance of the initial bargain and limit liability in case of efficient breach, and preclude unjust enrichment. The following distinctions exist between LD and penalty: 1) conditions for validity depend on punitive nature attributable to penalty but not LD; 2) calculation of penalty and LD; 3) right of the court to reduce amount of penalty. Thus legal uncertainty is created in all considered orders; Penalty is accepted in Civil law orders, but banned in Common law. In my opinion, efficiency of LD and penalty clauses may be enhanced by evaluation of the factors of fairness and awareness at the contract formation, assessment of actual balance and risk sharing between the negotiating powers and reasonability of pre-estimate, shifting focus of judiciary attention from the appraisal of the stipulated amount.

Price reduction is wide-incorporated monetary remedy under sales laws, but statistically is not often referred to. By default, depending of the statutory terms, reduction value may be defined by a court, an expert and the aggrieved party itself. This remedy gains functionality when compensation of damages is not adequate or difficult to acquire and the party would like to accept performance with defect and time is of essence. Pre negotiated mechanism of reduction value calculation should ensure legal certainty and increase efficiency. In my opinion, this remedy does not preclude efficient breach, providing response to the change of quality by ensuring corresponding change of the price. Utilization of this remedy in building and construction contracts affirms its functionality under rationally negotiated conditions.

Performance withholding is self-help, temporary and conditional remedy, recognized in all reviewed jurisdictions albeit lack of legislative regulation in Common law. Withholding usually precedes either termination or consequential mutual performance or provision of performance security. As a right it is often stipulated in the sales laws and adopted in many international codifications. Despite critics of inefficiency, I think that this measure ensures interests of both parties and does not preclude economically reasonable

termination of the contract, given that it meets standard of reasonability and good faith and is combined with mitigation duty.

Construction contract standards present an example of codified mixed contract, combining elements of sale of goods and provision of services, and applied to the long-term relationships in both national and international sphere, which allows to research different angles of remedial system incorporated in it.

In the construction industry standard forms of the general terms and conditions illustrate good example of rational combination of different types of the sanctions depending on each separate situation and for each particular breach of the agreement. On the example of several international and national standards (FIDIC and ORGALIME), I have analyzed effective fusion of liquidated damages and penalties for the delayed performance, defects in the performance and in case of termination for convenience; various damages' compensation divided depending on the category of the breach and type of losses to be compensated in the respective cases; application of specific performance and substitute performance.

Standard construction contracts adopt a system of balancing various breaches with the respective remedies, depending on the nature and interests of the parties, requiring diversified protection in every case. The role of tailored agreement or agreed deviation from the general terms is to provide for specific measurements of liquidated damages, values of penalties and limitations of aggregate liability or liability under the particular clause.

Usually in these type of contracts, resort to each remedy requires reasonable and fair attitude of both parties, which is incorporated in the standard terms, e.g. through the system of limitation periods for the presenting and settling claims, obligations to send mutual notifications and provide grace periods for the rectification in good will, implication of mitigation duty, introduction of the default chain or hierarchy of remedies and allowing termination of the contract in perspective when either other measures are exhausted or economic circumstances of the parties change. Such diversified and flexible

approach, providing the parties with wide liberty of discretion and autonomy, at the same time balanced with numerous restrictions, self-help mechanisms and system of expedited settlement of disputes, utilizes all available remedies and enhancing their economic efficiency within one contract.

In summation, despite all visible contradictions in the remedial systems across jurisdictions we can see a] general trend of convergence between various policies and their elements. Harmonization within Europe is stimulated by the institutions of the European Union and increasing role of its judiciary power. Enhanced complexity and instability of the world economy demands unified and discrete solutions for the international trade and level of protection for foreign counterparties equal to national. Complete legal certainty is an ideal and cannot be reached, but it can be increased along with economic efficiency of the elements of the contract law, where remedies play key role. Standard building and construction contracts present a successful example of harmonization and utilization of the whole specter of contractual remedies developed both on the international and national levels. These forms offer option of enhancing economic efficiency of each separate remedy as well as productive interplay between all remedies as elements of integrated system, which allow contractual parties to divide various interests within one contract and diversify levels of protection for each respective area, utilizing one or another appropriate function of each remedy.

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