Symposium Paper: Long-Term Relational Contracts and the *UNIDROIT Principles of International Commercial Contracts*

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ABSTRACT

This article considers how the *UNIDROIT Principles of International Commercial Contracts* ('UPICC') respond to the typical form of commercial contract—the relational contract. Relational contracts provide a 'framework' for relationships, allowing them to develop over time. The temporal element gives rise to peculiar issues, including: the need to accommodate changed circumstances; whether to keep the contract alive or terminate it in response to changed circumstances; contractual discretions and the role of fault and good faith; the role of contractual mechanisms for dealing with supervening risks. The article considers various of the provisions of the UPICC dealing with these issues and concludes with a consideration of possible new directions, including the proposal for a future edition of the UPICC that certain contracts can be terminated for 'just cause'.

As Australian commerce becomes more international in nature, we need a common framework—a 'new law merchant'—by which contractual relations are maintained. The Australian case law on relational contracts is thin. The UPICC will prod Australian courts and practitioners to grapple with these issues. However, that effort might stall if commercial parties believe the rules in the new law merchant are too open-textured, allowing too much judicial intervention in contracting practices.

1. Relational Contracts

The *UNIDROIT Principles of International Commercial Contracts* have made a surprisingly quick impact upon contract law globally. Professor Bonell and others have documented the

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immediate success of the *UNIDROIT Principles*.[1] They are in the form of a 'restatement', as if a code. However, they must inevitably develop the accretions of a common law system of reasoning, as they have gaps which must be filled and contain concepts that require interpretation.

The *UNIDROIT Principles* are a truly impressive exercise in reducing the core principles of contract law to writing—a new *lex mercatoria*.[2] The great bulk of these principles are uncontroversial and, as the *UNIDROIT Principles* demonstrate, there is a good deal of commonality between the common law and civil legal worlds in this respect.

The *UNIDROIT Principles* are therefore having an influence in many jurisdictions, not just European jurisdictions, with which Australian business is engaging in commerce. They will become more important if the vision of the Commonwealth Government is achieved. The Commonwealth Attorney-General has said that it is the view of the Government 'that we should promote the Federal Court as the regional hub for commercial litigation'.[3] If this vision is to become a reality, commercial parties should consider adopting a system of law that governs their contractual relationships that will be acceptable to non-Australian entities. The *UNIDROIT Principles* are an obvious choice.

Whether the *UNIDROIT Principles* continue to have influence will depend on whether they make sense to commercial people. This primarily means that they promote contractual certainty. They should also confine themselves to the core workings of contract law and not stray into territory that is better left to tort law, equity or restitution law. A key test is whether the principles deal adequately with 'relational contracts'. In the commercial world this is the typical contract: '[m]uch economic activity takes place within long-term, complex, perhaps multiparty contractual (or contract-like) relationships; behaviour is, in varying degrees, sheltered from market forces.'[4]

Relational contracts provide a 'framework' for transient and more permanent relationships and a 'norm of ultimate appeal when relations cease in fact to work'. Contracts are one of the central institutions of capitalism.[5] However, all contracts—but especially long-

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[1] Michael Joachim Bonell, 'UNIDROIT Principles 2004 – The New Edition of the Principles of International Commercial Contracts adopted by the International Institute for the Unification of Private Law' (2004) 1 *Uniform Law Review* 5. See also Stefan Vogenauer and Jan Kleinheisterkamp (eds), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)* (Oxford University Press, 2009).

[2] Klaus Peter Berger, *The Creeping Codification of the Lex Mercatoria* (Kluwer, The Hague, 2nd revised ed, 2010).

[3] Attorney-General Robert McClelland, Speech delivered at the Australian Financial Review Legal Conference 2008, Melbourne, 17 June 2008, <http://www.ag.gov.au/www/ministers/mcclelland.nsf/Page/Speeches_2008_SecondQuarter_17June2008-AustralianFinancialReviewLegalConference>. The Government is also promoting Australia as another venue for international arbitration in the region: see Luke Nottage and Richard Garnett, 'Introduction' in Luke Nottage and Richard Garnett (eds), *International Arbitration in Australia* (Federation Press, 2010) Part I.B.

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

[5] Karl Llewellyn, 'What Price Contract? An Essay in Perspective' (1931) 40 *Yale Law Journal,* 704. The seminal economic work is that of Oliver E Williamson, *The Economic Institutions of Capitalism* (Free Press, 1985). See also Oliver E Williamson, 'Transaction Cost Economics: The Natural Progression' (2010) 100 *American Economic Review,* 673. An overview of the 'new institutional economics' which considers the role that 'contract' plays in private

[footnote continued on the next page]

term contracts—are necessarily incomplete (unforeseen events are inevitable) and parties have a degree of 'discretion' in relation to how they perform their contractual obligations[6], which obligations can be 'evolutionary' in nature.[7]

The presence of *discretion* in the performance of contractual obligations gives rise to particular legal challenges, more like those found in public law. Justice Finn has stated that special rules should not apply to such contracts, but 'particular rules of contract law have greater or less ease of application in relational contract settings'.[8]

There are four areas to which attention needs to be paid. First, as Justice Finn also notes, there is a need, in relational contracts of significant duration, to adjust terms to accommodate changed or unforeseen circumstances.[9]

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

Third, the presence of discretion within the parties to the contract requires us to grapple with questions of fault: duties of good faith and cooperation, best efforts responsibilities, reasonableness, and duties of care and loyalty are intended to deal with opportunistic behaviour.[10] Many of the provisions dealing with relational contracts use the language of fault.

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

> The risk of supervening events, including changes in the law, can be allocated by the parties in the agreement. The risk allocation devices or terms used include express conditions, pricing provisions with escalation clauses, force majeure clauses, tailor-made terms aimed at particular events, and flexible quantity terms, such as requirements or output contracts. In addition, there are situations where the contract is silent but the promisor assumes the risk because it was actually foreseen or

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ordering is found in Eirik G Furubotn and Rudolf Richter, *Institutions & Economic Theory* (University of Michigan Press, 2nd ed, 2005) 135.

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

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

8 Ibid [224]. See also his Honour's contribution to this Issue.

9 Ibid [230].

10 George M Cohen, 'The Fault that Lies within Our Contract Law' (2009)107 *Michigan Law Review,* 1446.

> discussed in the pre-contract bargaining and not allocated by the agreement. Silence in the light of events foreshadowed at the time of contracting is, in effect, tacit risk allocation.[11]

2. Provisions Relevant to Excuse

A. *UNIDROIT Principles*

The *UNIDROIT Principles* have some important provisions—in some cases 'radical' (to an Anglo-Australian lawyer)[12]—in relation to these matters.

1. Hardship

Even where performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations (Article 6.2.1). That much is orthodox. However, this rule is made subject to the presence of hardship. As the now leading commentary states,[13] Article 6.2 is one of the more innovative aspects of the *UNIDROIT Principles*. Hardship is defined in Article 6.2.2:

> There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance has diminished, and
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> (a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
>
> (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
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> (c) the events are beyond the control of the disadvantaged party; and
>
> (d) the risk of the events was not assumed by the disadvantaged party.

It may be that this restates a form of frustration of purpose, although it is probably wider than the doctrine as currently understood. The language of this clause will strike an Australian lawyer as curious, e.g. 'equilibrium of the contract'. It does not mean 'fairness' nor 'equality'. It requires an understanding of the purpose and intended effect of the contract on risk and reward. However, the language is perhaps no more curious than the ill-adapted language of 'frustration', which struggles to encompass several possible concepts—frustration of purpose, impossibility and impracticability.

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[11] Richard E Speidel, *Contracts in Crises: Excuse Doctrine and Retrospective Government Acts* (Carolina Academic Press, 2007) 193-4.

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

[13] Vogenauer and Kleinheisterkamp, above n 1, 711. See also Nottage's contribution to this Issue.

The sting comes in the remedial provisions in Article 6.2.3. Reflecting the interest in keeping the transaction alive, the disadvantaged party is entitled to request renegotiation of the contract—the request must be made without undue delay and stating the grounds upon which it is based. That request does not itself entitle the party to withhold performance. The negotiations are subject to the obligation of good faith in Articles 1.7 and 2.1.15, and the obligation of cooperation (Article 5.1.3). Upon failure to reach agreement the parties can resort to court. The court may, if reasonable:

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

The power to adapt (reformulate or adjust) contracts will always be controversial. It has been used only once in the US. There is one only case where the court actually reformed the contract, but there is clearly power to do so and other cases have considered the circumstances in which that power might be exercised.[14]

2. Force Majeure

Article 7.1.7 contains a restatement of the force majeure doctrine. An excuse is given for non-performance if:

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

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

The controversial and messy position in relation to what happens by way of restitutionary remedies in both this and hardship is currently being considered.[15] It can do no worse than the legislative position in Australia.

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[14] *Aluminum Co of America Essex Group Inc* 499 E Supp 53 (WD Pa, 1980) (relief granted by price clause failed); *Oglebay Norton Co v Armco Inc* 556 NE 2d 515 (Ohio, 1990). See Richard E Speidel, *Contracts in Crises: Excuse Doctrine and Retrospective Government Acts* (Carolina Academic Press, 2007) 231-4, reviewing the case law (Professor Speidel is a long-time supporter of the power of adjustment in relational contracts). On the general right of adaptation see Nobert Horn (ed), *Adaptation and Renegotiation of Contracts in International Trade and Finance* (Kluwer, 1985); Klaus Peter Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators' (2003) 36 *Vanderbilt Journal of Transnational Law* 1347; Joseph M Perillo, 'Force Majeure and Hardship under the UNIDROIT Principles of International Commercial Contracts' (1997) 5 *Tulane Journal of International and Comparative Law* 5.

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

B. Other Sources of Law

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

1. Exemption under CISG

Article 79 of the *United Nations Convention on Contracts for the International Sale of Goods*(1980) contains an excuse for performance, so long as the failure can be proved to be due to an 'impediment' beyond the contracting party's control and that s/he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract, or to have avoided or overcome it or its consequences.[16] This provision is closer to a force majeure provision. It does not provide for court adjustment of the contract. It shields the party from a damages claim but leaves all other remedies intact.[17]

2. Impractibility under US Law

The US Uniform Commercial Code deals with these circumstances in a different manner. In *UCC § 2-615 – Excuse for Failure of Presupposed Conditions*, except so far as a seller has assumed a greater obligation, delay in performance in whole or in part is not a breach of the seller's duty if performance has become impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption of which the contract was made.[18] This section allows a seller to allocate production and deliveries in any way that is 'fair and reasonable' but might require ('must allocate') sales among its customers on a pro-rata basis.[19]

This is a 'new synthesis' of the development of the law regarding supervening events. It reflects a greater judicial intervention in US contract law than an Australian lawyer is comfortable with. Farnsworth states that '[t]he new synthesis candidly recognises that the judicial function is to determine whether, in the light of exceptional circumstances, justice requires a departure from the general rule that a promisor bears the risk of increased difficulty of performance'.[20] The rule has been adapted by the *Restatement (Second) of Contracts* §261. However it is a default rule that is often changed by express provisions, e.g. a force majeure clause.

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[16] S. Treaty Doc. 98-9 (1983); A/CONF.97/18 (1980); 19 ILM 668 (1980); 52 Fed. Reg. 6262-6280, 7737 (1987); 1489 UNTS 3 ('CISG', adopted in Australia).

[17] For a comparison of the UNIDROIT Principles and CISG see John Felemegas (ed), *An International Approach to the Interpretation of the United Nations Convention on Contracts for the International Sale of Goods (1980) as Uniform Sales Law* (Cambridge University Press, 2007) 236-46.

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

[19] Lord Morris of Borth-y-Gest expressed a view that a strong clause would be needed to allow breach of a contract by reference to other commitments: *Hong Guan and Co Limited v R Jumabhoy and Sons Limited* [1960] AC 684, 700. But see Donaldson J in *Intertradax SA v Lesieur-Tourteaux SARL* [1977] 2 Lloyd's Rep 146, 155. Compare the statement of law as stated in *The Super Servant Two* [1990] 1 Lloyds LR 1.

[20] E Allan Farnsworth, *Farnsworth on Contracts* (Aspen, 3rd ed, 2004) Part 9.6.

3. Principles of European Contract Law

The Principles of European Contract Law (PECL) are prepared by the Commission on European Contract Law, whose membership partly overlaps with that of the drafters of the *UNIDROIT Principles*.[21] Like the latter, they are not mandatory in nature and depend for their force on their acceptability to contracting parties (in this case, a class of person wider than commercial entities).

The PECL have, not surprisingly, many affinities with the *UNIDROIT Principles*. One set of similar provisions relates to 'Change of Circumstances'. Like the *UNIDROIT Principles*, Article 6.111 provides for court reformation of the contract. The PECL recognises that, if such a provision is absent, the parties to a contract might have an incentive to introduce appropriate clauses into their contracts. A leading commentary goes on to state: '[b]ut experience suggests that frequently the parties are not sufficiently sophisticated, or are too careless of their own interests, to do this; or they insert clauses which do not cover every eventuality'.[22]

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

The PECL also have similar provisions on 'Excuse Due to an Impediment'. Article 8.108 is drafted in similar terms to *UNIDROIT Principles* 7.1.7.

C. Possible New Directions – Termination for 'Just Cause'

UNIDROIT considered adding a new set of provisions in relation to termination of contracts for 'just cause' into the forthcoming third edition of the *UNIDROIT Principles*. However, these proved to be controversial and the proposal was deferred for a fourth or later edition.[23]

The notion of a just cause was the critical term. The relevant draft stated:

> There is a just cause if, having regard to all the circumstances of the specific case and balancing the interests of both parties, the terminating party cannot reasonably be expected to continue the contractual relationship until the agreed termination date or until the end of the notice.[24]

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[21] Luke Nottage 'Convergence, Divergence, and the Middle Way in Unifying or Harmonising Private Law' (2004) 1 *Annual of German and European Law* 166, accessed online at <http://ssrn.com/abstract=837104>.

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

[23] Professor François Dessemontet, *Position Paper with Draft Provisions on Termination of Long Term Contracts for Just Cause* (Study L – Doc. 104, January 2007); *Draft Chapter on Termination of Long Term Contracts for Just Cause* (Study L – Doc. 109, January 2009).

[24] Ibid 12.

Whilst a lawyer in the Anglo-Australian tradition will probably think first of principles of breach allowing termination, and then of equitable principles, the examples given in the discussion paper were broader:

- the loss of mutual trust between parties to a licensing agreement due to late performance;
- sudden dramatic diminution of the financial capacity of a lessee; and
- risk of imminent insolvency of a borrower.

Conclusion

As Australian commerce grows more international in nature, there will be a need to find a common 'framework' by which contractual relationships are maintained. The *UNIDROIT Principles* and PECL are obvious sources of rules and institution building in this regard. This creates a fundamentally different legal environment in relation to risk-bearing for supervening events. This is not necessarily a good or bad thing, but it is something with which Australian business should come to grips. The case law and literature in Australia about relational contracts is thin. The inclusion of concepts that deal with relational contracts into the *UNIDROIT Principles* is a challenge to Australian lawyers and courts to grapple with the issues that arise in a relational setting.

The *UNIDROIT Principles* will continue to prod us along this direction. However, that effort may stall if commercial parties believe that the rules in the new law merchant are too open-textured, allowing too much judicial intervention in contracting practices. The debate about these matters in Australia has barely started. I look forward to the next edition of the *UNIDROIT Principles* and a healthy debate about the role that they play in commercial contracts in Australia.