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Unwinding of Failed Contracts

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by

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I. Introduction*

It will be recalled that the discussion in Rome in June last year focused nearly exclusively on the effects of *termination*. The main issue that was brought up repeatedly was whether the restitution regime proposed in my position paper was suitable for contracts to be performed over a period of time (or: “successive” contracts [G.H. Treitel]). That discussion, to some extent, overshadowed the discussion of all other issues. It is indeed a very important issue. At the same time, however, some thought must also be devoted to the effects of *avoidance* (both with regard to “once-off”, or “instantaneous” [G.H. Treitel], contracts and to contracts to be performed over a period of time) and to the effects of *termination* in the case of “once-off” contracts (the paradigmatic example being contracts of sale; henceforth, therefore, I will refer simply to contracts of sale). Because it was so obviously the central focus of attention in Rome, the present paper will commence with restitution after termination. For the sake of convenience, and following the structure of both the present Art. 7.3.6 Unidroit Principles of International Commercial Contracts (PICC) and Art. III.-3:511 Draft Common Frame of Reference (DCFR), it is proposed to look at restitution following termination concerning contracts of sale first (II.) before venturing into the area of restitution following termination concerning contracts to be performed over a period of time (III.). We will then look at restitution following avoidance concerning contracts of sale (IV.) and contracts to be performed over a period of time (V.). The purpose of this paper is to highlight the issues on which agreement has to be reached before the Draft contained in my position paper (*sub* 47.) can be revised. The terms “avoidance” and “termination” are used in the way in which these terms are used in Chapter 3 (avoidance) and Chapter 7, Section 3 (termination) of the Unidroit Principles of International Commercial Contracts 2004.

* I am very grateful to Roy Goode for his comments on an earlier draft of this paper.

II. Restitution following termination concerning contracts of sale

1) Both parties may claim restitution of whatever they have supplied under the contract. That is the rule in the present Art. 7.3.6 (1). It has been taken up in rule (1) of my position paper and no objection was raised against it in Rome (for contracts of sale!). The Common Frame of Reference (henceforth: DCFR) is in conformity with this (III.-3:511 (1)).

2) The obligations of both parties have to be performed concurrently. See present Art. 7.3.6 (1) and rule (7) of the position paper. No objection in Rome. The DCFR expresses the same idea but uses a different term (both obligations are “reciprocal”).

3) Should there be a specific provision on partial termination? The matter is addressed in the parallel rule of Art. 3.17 (2) (“... or the part of it avoided”) but not in Art. 7.3.6 (1), in spite of the fact that a contract can not only be partly avoided but also partly be terminated. With regard to termination, the situation is only envisaged in the Official Comment. I have no strong feelings whether it should be taken care of in the black-letter rules or only in the comments (as being self-evident). In the former case, the rule might look like this: “On termination either party may claim restitution of whatever it has supplied under the contract, or the part of it terminated, ...”.

4) Restitution normally has to be made in kind: see Art. 7.3.6 (1); rules (1) and (2) of the position paper; no objection in Rome. This is in accordance with Art. III.-3:511 (1) - (4) DCFR; see Official Comment, sub B: “Where money has been received, the amount received ... has to be repaid. Transferable property must be returned in kind”.

5) If restitution in kind is not possible, “an allowance should be made in money” (Art. 7.3.6 (1)). It is not clear to me what allowance means. That is why the position paper suggested “compensation for value”: rule (2), meaning the (objective) market value at the moment when restitution in kind becomes impossible, see position paper sub 14. There has been some discussion about this in Rome. Hartkamp suggested to be more precise and to adopt one of the following two formulas: “the market value of performance”, or “the value which the performance has had for the receiving party”. However, a majority was in favour of retaining the term “allowance”. But that decision does not absolve us from addressing the issue in the Official Comment. So the question

remains: shall the recipient have to pay the objective or subjective value of the performance? Illustration 3 on p. 229 appears to come down in favour of the subjective value (allowance must be “measured by the value that work has for B”). The position paper suggests the objective value (*sub* 8. and 14.). But whichever approach we decide to adopt: why not document that decision in the black-letter rules? The DCFR (III.-3:511 (4) imposes an obligation to return the “value” of the benefit. III.-3:513 has detailed rules on how the value has to be calculated. These rules should be examined if it is decided to substitute “value” for “allowance”.

6) Art. 7.3.6, at present, adds another qualification: if restitution in kind is not possible, allowance should be made in money “whenever reasonable”. That qualification is lacking in Art. 3.17 (2). The Official Comment (p. 230) states that it is designed to make clear that allowance should only be made if, and to the extent that, the performance received has conferred a benefit on the party claiming restitution. The illustration provided in this context corresponds to the one given in the Comment to Art. 3.17 (p. 115). The phrase “whenever reasonable” is thus intended to bring out a point that is taken to be implicit in Art. 3.17 (1). At the Rome meeting a decision was taken to retain the qualification with regard to termination and to extend it also to avoidance. It may be worth considering whether one should not be more specific and adopt guidelines for calculating the value of the benefit received along the lines of III.-3:513 DCFR. But that depends on whether we are willing to substitute “value” for “allowance”.

7) Should the rule (value/allowance has to be paid if restitution in kind is not possible) also be extended to cases where restitution in kind is not “appropriate”? This is what Art. 7.3.6 (1) states at present. The position paper advised against that extension. According to the Official Comment (p. 230), the phrase “or [not] appropriate” is supposed, in particular, to cover situations where the aggrieved party has received part of the performance and wants to retain it. But the aggrieved party should then terminate the contract only to the extent that he is aggrieved. If B buys two books that have appeared as part of a series from A, and only one of those books is defective, he should terminate the contract only with regard to that book if he wants to keep the other. There has been some discussion about the phrase “or [not] appropriate” in Rome. But that discussion was dominated by the concern that a rule only covering situations where restitution is impossible might not be flexible enough for contracts to be performed over

a period of time. No indication was given whether this clause was regarded as necessary also for contracts of sale, and which type of situation it was supposed to cover. III.-3:511 (3) DCFR envisages the situation that returning a piece of property in kind (by retransferring it) is too onerous (“... if a transfer would cause unreasonable effort or expense, the benefit may be returned by paying its value”). The following illustration is provided in the Unidroit Principles (p. 329): “A has painted a fresco which has been mounted on a wall in B’s house and for which B has not paid A. Although it would be physically possible to dismantle the fresco, the costs would be disproportionately high. A cannot claim back the fresco but only payment representing its value”.

8) An issue to which considerable discussion was devoted in Rome is whether the duty to return what has been performed should include the benefits derived from such performance. The Unidroit Principles, so far, are silent on the matter. The position paper proposed a rule relating to benefits (“... any performance received under it, as well as the benefits derived from such performance, have to be returned”). Art. 84 CISG takes the same view: the seller has to pay interest on the price that he is bound to refund, and the buyer must account to the seller “for all benefits which he has derived from the goods or part of them”. This essentially corresponds to III.-3:511 (5) DCFR: “The obligation to return a benefit extends to any natural or legal fruits received from the benefit”. (The term benefit is here used to describe the money, or the object, or the services, etc. that the one party has received as a result of the other’s performance.) In Rome, there was majority support for a rule along these lines. But I was asked to provide examples so that the Working Group might be able better to assess the relevance of the rule, and to discuss possible limitations or exceptions. These examples are contained in Appendix C. They deal with what civilian lawyers refer to as natural fruits (a), indirect fruits (or civil fruits) (b), legal fruits (c), interest (d), and value for the use of a thing (e) - (g). The solutions take their cue from the way in which Art. 84 CISG is interpreted (with the exception that legal fruits = proceeds of a right are not, of course, covered by Art. 84 CISG because CISG only deals with the sale of goods). Natural and indirect fruits have to be handed over, as far as they have actually been derived (though for indirect fruits the actual remuneration received is said to be relevant only as long as it remains within the normal commercial limits: Schlechtriem/Schwenzer/Hornung, Art. 84, n. 18). Legal fruits should be dealt with in the same way as natural fruits. Concerning interest, it will have to be decided whether it

is payable only as far as it has actually been received, or whether a certain rate of interest is to be due, in any event, where a sum of money has to be returned. In the latter case one might have to have a special rule concerning interest; see Art. 84 CISG. Benefits of use: the mere possibility of being able to use an object has a value. That value, measured objectively, i.e. by reference to the market rate, has to be paid, after termination, by the purchaser to the seller. This does not include a duty to hand over any income derived from the recipient having had the car at his disposal. It will have to be determined whether an attempt should be made to provide a detailed regulation along the lines suggested above or whether the matter should be dealt with by a single, comprehensive formula which would then have to be elucidated in the comments. I would prefer the latter course (it is in tune with CISG and the DCFR). The question then is, however, whether the term “benefits derived from such performance” captures adequately what is meant. N.B. that the DCFR refers to natural and legal fruits. But what about the benefits of use?

9) Closely associated with the former point is the question whether there should be a rule according to which there should be a duty to pay compensation for value for the benefits that a party fails to derive from the performance in accordance with ordinary business practice. The problem is not dealt with in Art. 84 CISG and is, consequently, disputed. In the position paper it was suggested to include such rule; see rule (4) as well as the position paper *sub* 16. The majority in Rome came out against this rule. But it may be necessary to review that decision depending on what line will be adopted with regard to benefits generally; see, for example, Appendix C, *sub* d) (interest!). Also, much of the pertinent discussion in Rome was conducted without proper appreciation of the exact range of the concept of “benefit derived from such performance”, for it was assumed by some contributors to the debate that income derived from the goods received would also have to be covered by it. I would, therefore, suggest to remain open-minded about the matter when discussing the benefit-rule in general.

10) It was suggested in Rome by Cr peau that the benefit rule should be amended in line with Art. 1704 of the Civil Code of Qu bec: the benefits of the property received should remain with the recipient if he was in good faith, i.e. if he did not know the reason for the contract being terminated. There was some discussion about this proposed amendment but no decision was reached. The Cr peau amendment would

constitute a deviation from both CISG and the DCFR. Also, the Crépeau amendment would largely turn the benefit rule on its head. In a sale situation it is often the purchaser who terminates the contract because of non-conformity. He is, however, always in good faith, for otherwise he would not have been able to terminate the contract (see Art. 35 (3) CISG); that point was made in Rome by Goode. Moreover, the seller also, very often, will be unaware of the non-conformity; thus, he is also in good faith and would, according to the Crépeau-rule, not have to pay any interest on the purchase price either. If the contract is terminated for other reasons both parties are also usually in good faith until the moment when the terminating event occurs. Acceptance of the Crépeau amendment would, therefore, lead to just about all cases listed in Appendix C having to be decided differently. The general rule would be: benefits do not have to be returned unless the recipient has not been in good faith. In other words: the duty to hand over the benefits is seen as a kind of penalty which would be unfair on someone who is in good faith. But I do not think that this is the proper way of conceptualizing the benefit-rule. If, in case scenario a) (Appendix C) F has to return not only the sheep but also the lambs, he is not being penalized. He just has to return what he has received. And he has received both the sheep and the product of the sheep. On the contrary: one would have to ask what it is that should entitle F to keep the lambs even though he has to return the sheep. Certainly not the contract, for that is being “unwound”. It can no longer serve as a justification for any transfer of value to F. It is not, perhaps, without significance that the Crépeau rule was misunderstood by a number of participants in the debate. Thus, it was suggested that what was at stake was the prohibition of inconsistent behaviour (see Art. 1.8): a party may not ask for restitution of the benefits if he knows that the other party had reasonably acted in reliance on the validity of the contract. But that is not what the Crépeau rule intends or implies. Nor indeed is there anything inconsistent in claiming back something which the recipient has received in good faith, i.e. not knowing that he might have to hand it over to the person now claiming that object. The only possible worry one can have concerning a benefits rule such as the one suggested in the position paper, in Art. 84 CISG or in III.-3:511 (5) DCFR is that the recipient may have made investments in producing or maintaining the fruits: in example a) the costs for a vet who has to attend the sheep while giving birth, the costs for nourishing the lambs, etc. That, however, is taken care of by rule (5) of the position paper on compensation for expenses.

11) There was a good deal of discussion in Rome relating to the question of risk. That discussion was strongly coloured by two issues: Can one have one and the same rule for all types of contracts (particularly: what about contracts to be performed over a period of time)? And what about the situation when the object is destroyed *after* termination of the contract? The answer to the first question is that we are only looking at contracts of sale, in this part of the paper. The answer to the second question is that the rules proposed in Rome are dealing only with cases where the object of the sale has been handed over and is destroyed *before* termination of the contract. The situation where the object is destroyed (or deteriorates) *after* the contract has been terminated does not specifically have to be addressed. After termination, the purchaser is under a duty to return the object received. Any non-performance of that duty gives the seller a right to claim damages according to Art. 7.4.1, unless the non-performance is excused under Art. 7.1.7 (*force majeure*). In other words: from the moment of termination the normal rules on non-performance apply. That can be explained in the comments.

12) The risk-question can be approached from two different points of view: Does the purchaser lose his right to terminate if he cannot return the object that he has received? The consequence would be that since he is no longer allowed to terminate, he will not be able to reclaim whatever he has given (i.e. the purchase price). Or is he still allowed to terminate the contract, and thus to reclaim the purchase price, but is under a duty to make good the value of the object received? In both cases the risk is on the shoulders of the purchaser. This, I think, is as it should be (as a general rule for sales contracts). After delivery, the object of the sale is in the purchaser's sphere of influence and control. If it is accepted that the risk should be on the purchaser, the question arises which of the two approaches sketched above should be adopted. The main difference is this: if the right of termination is excluded, the values remain as exchanged under the contract of sale; but if restitution in kind is simply replaced with a liability to make good the value received, the values are retransferred to the *status quo ante*. In other words: under the restitution-of-value regime the purchaser can escape from a bad bargain. That may be regarded as an undeserved windfall. More compelling, however, is another consideration: as long as a legal system is prepared to grant a right of termination on account of breach of contract, and as long as it imposes duties to make restitution consequent upon termination, it accepts that there has to be a retransfer of values. The situation should not be different merely as a result of the fact that one party is unable to

render restitution in kind. It is, therefore, widely agreed that, between the two possible solutions, the imposition of a liability to make good the value is more subtle and flexible than an exclusion of the right of termination. Thus, in particular, it would hardly be appropriate to exclude the right of termination in all cases of *deterioration* of the object received. That is, why it is often limited to instances of “significant deterioration”. However, it is not always easy to determine when a deterioration is significant. Nor does there appear to be a good reason to draw a sharp, and necessarily arbitrary, line in order to attribute the risk either the one way or the other. But the right to terminate can only either be excluded or not excluded. It must be all or nothing. The purchaser’s liability to make good the value (or: to make appropriate allowance??), on the other hand, can be flexibly adjusted depending on the extent to which there has been a deterioration. No objection was raised in Rome against this way of proceeding.

13) It is obvious that there will have to be an exception to the rule just envisaged (= rule (3) of the original position paper) for cases where the object deteriorates, or is destroyed, as a result of the defect inherent in it. In the position paper it was proposed to generalize this idea and to state that the value does not have to be made good, if the destruction or deterioration is attributable to the other party (see rule (3); and position paper, *sub* 29.). No objection was raised against this in Rome.

14) There are a few other issues that were not discussed in Rome, particularly: (i) Does the duty to pay compensation have to be excluded when the destruction or deterioration would also have occurred had the object still been with the seller? (ii) Does deterioration resulting from normal use of the object have to be disregarded? The answer given in the position paper to (i) was no (*sub* 30.), the answer to (ii) was yes (*sub* 32.); hence the way in which rule (3) was ultimately drafted.

15) Rule (5) of the position paper (concerning expenses) was accepted in Rome subject to the proviso that the words “expenses incurred on the object received” should be replaced with “expenses linked to the performance received”. For a rule covering contracts of sale, however, one might like to revert to the former formulation.

III. Restitution following termination concerning contracts to be performed over a period of time

1) Art. 7.3.6 (2) already provides a special rule for contracts that have to be performed over a period of time: as long as the contract is divisible, restitution can only be claimed for the period after termination has taken effect. The reason, as I see it, is that it can be inconvenient to unravel performances that have been made in the past, over a long period of time. In the position paper it was suggested to introduce a further qualification, i.e. that “neither of the parties has a reasonable interest in the mutual restoration of the past performances”. An example was given in the position paper *sub* 43.: A contracts regularly to service B’s fire-engines. After three years, it turns out that he has not in fact regularly serviced the fire-engines but has only once or twice done the barest minimum to keep them going. Here, it would hardly be equitable to leave matters as they are, as far as the past three years are concerned. After all, B has paid much more than the value of the services he has received. In Rome it was objected that this was just a question of damages. But is that really correct? B does not appear to have sustained any harm as a result of A’s partial non-performance. Or can one say that he has suffered damages as a result of having paid for a performance that has only partly been rendered? Further questions: which of the issues discussed under II. needs to be taken care of for continuing contracts? The answer probably is: none, for they are all based on the idea that the performances have to be returned. Do we really have to consider the issue within the framework of the present paper in view of the fact that a separate paper will be prepared on the topic of termination of long-term contracts for just cause? The paper of Dessemontet on that topic could not be discussed in Rome. But it is distinctly possible that it will lead to a rule very similar to § 314 BGB (see also our discussion in Rome in the previous year). We would then have a rule doing exactly the kind of job that we envisage: long-term (or continuing) contracts can be terminated (in German law we use the term “Kündigung” in this context) for just cause; and breach of contract will certainly be a just cause. The result is: the contract comes to an end, there is no unravelling of the past, damages claims are preserved. (Note: III.-3:512 DCFR addresses the problem in the following way: “(1) Restitution is not required where the performance was due in separate parts or was otherwise divisible and what was received by each party resulted from due performance of a part for which counter-performance was duly made. (2) Paragraph (1) does not, however, apply if what was received by the

terminating party was properly rejected under rule III.-3:510 (Property reduced in value) or if the value of a non-transferable benefit received by the terminating party has been eliminated or fundamentally reduced as a result of the other party's non-performance"; the Comments explaining these provisions are reproduced as Appendix B to this document.

2) Do we need *further* rules on restitution following termination concerning contracts to be performed over a period of time? I do not think so. That view is based on two observations. (a) In the civilian codes, to my knowledge, we do not have any such rules; nor does the DCFR have any rule other than the one just quoted. (b) Roy Goode kindly supplied a number of case scenarios concerning contracts to be performed over a period of time. All these scenarios can adequately be dealt with by the present Art. 7.3.6 (2) PICC; see Appendix D.

IV. Restitution following avoidance concerning contracts of sale

Very little discussion was devoted to this issue in Rome. I would therefore, for the time being, suggest a regulation along the lines of rules (1)-(5) and (7) mapped out in the position paper. The only special issues that need to be considered with regard to avoidance are those discussed in the position paper, *sub* 38. and 39. (protection of minors, fraudulent misrepresentation). Since the matter was not discussed in Rome, no change is proposed. But it might be appropriate to revisit the topic "restitution following avoidance" after the necessary decisions concerning restitution following termination have been taken. It would have to be asked whether these also have an impact on restitution following avoidance.

V. Restitution following avoidance concerning continuing contracts

So far, there is no special rule dealing with this situation. However, it may be equally inconvenient to return (the value of) performances that may have been regularly made for a number of years. The reason why the problem is not dealt with is, probably, that as a result of avoidance the contract is considered never to have existed. How can it be taken to provide a basis for the retention of performances made in fulfilment of that contract? But there is an argument also in these cases for leaving the past alone and for recognizing the normative force of the factual. This would be in accordance with what

is done at least in some legal systems (e.g. German law concerning partnership contracts and contracts of services).

UNIDROIT Principles

Art. 7.3.6 (« Restitution »)

(1) On termination of the contract either party may claim restitution of whatever it has supplied, provided that such party concurrently makes restitution of whatever it has received. If restitution in kind is not possible or appropriate allowance should be made in money whenever reasonable.

(2) However, if performance of the contract has extended over a period of time and the contract is divisible, such restitution can only be claimed for the period after termination has taken effect.

Draft Common Frame of Reference

Subsection 4: Restitution

III.-3:511: Restitution of benefits received by performance

(1) On termination under this Section a party (the recipient) who has received any benefit by the other's performance of obligations under the contract is obliged to return it. Where both parties have obligations to return, the obligations are reciprocal.

(2) If the performance was a payment of money, the amount received is to be repaid.

(3) To the extent that the benefit (not being money) is transferable, it is to be returned by transferring it. However, if a transfer would cause unreasonable effort or expense, the benefit may be returned by paying its value.

(4) To the extent that the benefit is not transferable it is to be returned by paying its value in accordance with III.-3:513(Payment of value of benefit).

(5) The obligation to return a benefit extends to any natural or legal fruits received from the benefit.

III.-3:512: When restitution not required

(1) Restitution is not required where the performance was due in separate parts or was otherwise divisible and what was received by each party resulted from due performance of a part for which counter-performance was duly made.

(2) Paragraph (1) does not, however, apply if what was received by the terminating party was properly rejected under III. -3:510 (Property reduced in value) or if the value of a non-transferable benefit received by the terminating party has been eliminated or fundamentally reduced as a result of the other party's non-performance.

III. - 3:513: Payment of value of benefit

(1) The recipient is obliged to:

- (a) pay the value (at the time of performance) of a benefit which is not transferable or which ceases to be transferable before the time when it is to be returned; and**
- (b) pay recompense for any reduction in the value of a returnable benefit as a result of a change in the condition of the benefit between the time of receipt and the time when it is to be returned.**

(2) Where there was an agreed price the value of the benefit is that proportion of the price which the value of the actual performance bears to the value of the promised performance. Where no price was agreed the value of the benefit is the sum of money which a willing and capable provider and a willing and capable recipient, knowing of any non-conformity, would lawfully have agreed.

(3) The recipient's liability to pay the value of a benefit is reduced to the extent that as a result of a non-performance of an obligation owed by the other party to the recipient:

- (a) the benefit cannot be returned in essentially the same condition as when it was received: or**
- (b) the recipient is compelled without compensation either to dispose of it or to sustain a disadvantage in order to preserve it.**

(4) The recipient's liability to pay the value of a benefit is likewise reduced to the extent that it cannot be returned in the same condition as when it was received as a result of conduct of the recipient in the reasonable, but mistaken, belief that there was no non-conformity.

111.-3:514: Use and improvements

(1) The recipient is obliged to pay a reasonable amount for any use which the recipient makes of the benefit except in so far as the recipient is liable under III. - 3:513 (Payment of value of benefit) paragraph (1) in respect of that use.

(2) A recipient who has improved a benefit which the recipient is obliged under this Section to return has a right to payment of the value of improvements if the other party can readily obtain that value by dealing with the benefit unless:

- (a) the improvement was a non-performance of an obligation owed by the recipient to the other party; or**
- (b) the recipient made the improvement when the recipient knew or could reasonably be expected to know that the benefit would have to be returned.**

111.-3:515: Liabilities arising after time when return due

(1) The recipient is obliged to:

- (a) pay the value (at the time of performance) of a benefit which ceases to be transferable after the time when its return was due: and**
- (b) pay recompense for any reduction in the value of a returnable benefit as a result of a change in the condition of the benefit after the time when its return was due.**

(2) If the benefit is disposed of after the time when return was due, the value to be paid is the value of any proceeds, if this is greater.

(3) Other liabilities arising from non-performance of an obligation to return a benefit are unaffected.

Appendix B

Comments to III.-3:512 DCFR

A. Application to obligations to be performed in parts or otherwise divisible

Where an obligation is to be performed in parts or instalments or is otherwise divisible, (for example, if it is to be performed continuously over a period of time and separate payments can be apportioned to units of time within the period), the duly completed parts of the performance on both sides do not normally have to be unravelled. The rules on restitution apply, however, to payments made in respect of so much of the obligation as was not fully performed.

Illustration 1

A has given B advance payment for the construction of 12 houses. B builds only 3 houses, and A terminates the contractual relationship. A can claim back the advance payment for the 9 houses which were not built but not for the three which were built.

Illustration 2

Company X has leased machinery from company Y for a period of 24 months. Y has to inspect the machinery once a week and perform maintenance operations. Payment of rent is to be made monthly. For 10 months the obligations are properly performed on both sides. Then Y's performance becomes fundamentally unsatisfactory to such an extent that X can hardly use the machinery. After 3 months of this, X concludes that it cannot rely on Y's performance improving for the future and terminates the whole contractual relationship for fundamental non-performance. X will have a claim for restitution of all or part of the rent paid for the 3 months when Y's obligations were not performed but has no claim in relation to the first 10 months when the parties' obligations were performed on both sides.

B. Exception for cases where what was received is now of no or little value to recipient

Even where an obligation is to be performed in divisible parts or over a period of time, and even where there has been full performance on both sides in respect of one part or period, there is a possibility that one party may have received from the other some property which is of no value to the recipient because the termination of the contractual relationship means

that the recipient will not receive the rest of the performance. In such cases the recipient has the right under III.-3:510 (Property reduced in value) to reject the useless property and is relieved of the obligation to pay the price. If the price has already been paid paragraph (2) of the present Article enables it to be recovered.

Illustration 3

A complete computer system is to be installed and paid for one component at a time so that it can be fitted into a new office as the building is being built. An essential item is not delivered and the buyer terminates the contractual relationship for fundamental non-performance. The buyer may reject the components already received and recover the price paid for them.

The recipient could in the alternative claim damages or a reduction in the price for the reduced value that the property received now has. However it will often be more convenient simply to return the unwanted property than to have to dispose of it some other way. There will be a considerable advantage in rejecting the property if it has not yet been paid for, as the recipient can thus avoid having to pay even a reduced price.

Appendix C

Benefits

a) F has bought ten sheep guaranteed to be pregnant by a particular type of ram. When the lambs are born it is clear that they are of another type. F terminates for fundamental non-performance, and reclaims the price. F must return both the sheep and the lambs (example taken from CFR, Official Comments to III.-3:511, H).

b) B purchases from A a house which he then lets on lease to a third person. After termination of the contract between A and B, B has to retransfer the house plus the rent that he has received.

c) D purchases from C the licence to print and distribute a book. After six months C terminates for breach of contract. D has to hand over the income he has made by exploiting the licence.

d) H sells a car to J. The car is delivered and the purchase price is paid. Six months later it turns out that the car is defective. J terminates the contract. As a result, H has to pay back the purchase price plus interest from the date on which the price was paid. Legal systems take a different view as to whether (i) interest only has to be paid if, and to the extent that, it has actually been earned (as a result of the purchase price having been paid into the recipient's bank account), (ii) interest has to be paid always, no matter whether the recipient has actually earned interest or not (e.g. A has to pay the customary interest rate at the seller's place of business; that is the solution according to CISG), or (iii) interest has to be paid to the extent that the purchaser has received interest or has failed to receive it in accordance with ordinary business practice.

e) The facts are as under d) but this time we are looking at J's duty to return the car. It includes a compensation for the value of having been able to use the car every day for commuting between his home and his place of work.

f) The facts are as under d) and e), but J has used the car as a taxi. It is generally agreed that J does not have to hand over the profits he has made. These profits have been made by means of using the car; they are not the equivalent of the mere fact of having a car at one's disposal.

g) A Limousine Company buys ten new cars. One of the cars blows up after two months because of a defect in the petrol tank which affects all ten cars. The Limousine Company terminates the contract for that reason. We are only concerned here with the nine "surviving" cars. These cars will have to be returned plus the value for the use during two months. The Limousine Company will not have to hand over the income derived from renting out the nine cars during those two months (example kindly supplied by Professor Chappuis).

Appendix D

Examples relating to contracts to be performed over a period of time (provided by Roy Goode)

a) Equipment lease

A leases equipment to B for three years at a rental of \$10,000 a month. B pays punctually for the first two months but then fails to make any further payments despite repeated requests by A. After the lapse of five months A terminates the lease. A is entitled to retain the \$20,000 already received and to recover the \$30,000 accrued due, together with damages for the present value of the future rentals.

b) Construction contract

O engages C to build a factory for the sum of 20 million Euro over a period of two years. Payment is to be made in stages against architects' certificates stating the value of the work carried out for the stage in question. Architects' certificates are issued during the first 12 months of the contract for a total of 8 million Euro, of which O has paid 7 million Euro. C then stops work because it has been offered a more lucrative contract elsewhere, and O terminates its contract with C. O is entitled to retain the benefit of the work performed so far, to have it completed by another contractor and to recover any additional costs thereby incurred, together with damages for any delay. C is entitled to retain the 7 million euros it has received and to be paid, or to set off against its liability, the 1 million Euro it is still owed.

c) Contract for services

H, a hospital, engages C to carry out cleaning services for the hospital, the contract to run for three years. After a year C informs H it cannot continue with the cleaning services unless the price is doubled. H refuses to agree and C ceases to provide the services. On terminating the contract H can recover damages for any additional expense it incurs in

hiring another cleaning firm, while C is entitled to retain the payments it has received for services already provided.

d) Agency

P engages A as its commercial agent to promote the sale of A's goods in a given geographical area in return for a commission on sales. Neither P nor A has any connection with an EU Member States and the geographical area is outside the EU [NB: this is to avoid discussion of the EU agency Directive]. After 3 years' hard work A has built up a substantial network of customers. P then decides to terminate the agency agreement, which still has two years to run, and service the network direct. A is entitled to any commission due but unpaid and also to compensation for loss of the opportunity to earn future commission for the remaining period of the contract. Neither party has to give restitution of benefits already received.

* * *

Comments on the examples by R. Zimmermann

Equipment Lease. I agree entirely that what you propose is the correct solution. It follows from PICC, as they stand. A can retain the 20,000 already received in terms of Art. 7.3.6 (2); he can recover the 30.000 on the basis of the contract of lease (the contract is terminated only *pro futuro*); and he can claim damages because of Art. 7.3.5 (2).

Construction Contract. Again, I agree with the result. Again, it follows from PICC, as they stand. O is entitled to retain the benefit of the work performed, so far (Art. 7.3.6 (2)); O is entitled to have the contract completed by another contractor (that follows from the fact that the contract with C has been terminated and that O is therefore free to obtain the services of another contractor); O can recover the additional costs plus damages for delay (Art. 7.4.2 in conjunction with Art. 7.3.5 (2)); C can retain the 7 million (Art. 7.3.6 (2)); C is entitled to another 1 million (this is based on the original contract which has only been terminated *pro futuro*); C can set this claim off against O's damages claim (Art. 8.1).

Contract for Services. There is, of course, agreement on the result. It follows from PICC, as they stand: H can recover damages for any additional expense (Art. 7.4.1 in conjunction

with Art. 7.3.5 (2)); C is entitled to retain the payments received for the services provided (Art. 7.3.6 (2)).

Agency. Again agreement as to the result which follows from an application of the PICC. A is entitled to any commission due but unpaid as a result of the contract which is only terminated for the future. A is also entitled to recover his loss because by terminating the contract P has committed a breach of contract. Neither party has to give back the benefits already received: this also follows from the fact that termination operates only *pro futuro*. (Art. 7.3.6 (2) is not applicable in this situation because P did not have a right of termination under Art. 7.3.1 [there was no failure of performance on the part of A]).

Note by R. Zimmermann

Points of agreement and disagreement with Roy Goode in the light of our recent exchange of views

(a) We agree that there should be one set of rules covering what G.H. Treitel refers to as “instantaneous contracts” (paradigm example: “once-off” contracts of sale) and another set of rules (or possibly only one rule) covering what the Unidroit Principles refer to a contract to be performed over a period of time (G.H. Treitel: “successive” contracts). This is also the structure envisaged in the present Art. 7.3.6 PICC.

(b) We agree that for the sake of convenience, and in line with the present Art. 7.3.6, we may discuss the rules on contracts of sale first. That does not, however, imply any judgment on the commercial importance of these rules *vis-à-vis* the rules concerning contracts to be performed over a period of time; nor does it prejudice the sequence in which the rules will ultimately appear in the revised Unidroit PICC. The latter may be a matter of drafting convenience, after the two sets of rules have been devised.

(c) I think we also agree that for contracts to be performed over a period of time we do not need much more than the rule presently contained in Art. 7.3.6 (2) PICC (possibly with the modification suggested under III.1) of the present paper).

(d) There is not yet agreement on terminology. Roy objects to the terms “long-term contracts” and “continuing contracts”. That is why I have now reverted to the term used in Art. 7.3.6 (2) PICC, as it stands: contracts to be performed over a period of time. I hope that this is acceptable.

(e) There still appears to be no agreement on what should be done with regard to contracts to be performed by instalments, particularly instalment sales. Roy would like to see a separate rule. My own view is that they are covered by the term “contracts to be performed over a period of time” and that the rule laid down in Art. 7.3.6 (2) PICC should be applied to them. The same view appears to be taken by the draftsmen of Art. III.-3:512 DCFR, for

they put obligations to be performed in parts or instalments, and contracts to be performed over a period of time, on a par (as long, obviously, as they are divisible).

(f) Finally, there is an underlying disagreement on the function of the remedy of termination. Roy in a message from 10 January says that “the function of the remedy [sc.: termination] is to put the innocent party in as nearly as possible the same position as he would have been in if the contract had been performed”. I disagree because that, in my view, is the function of damages. If the innocent party decides to terminate the contract, he does so because he wants to be rid of it. The reason usually is that he wants to have certainty on whether he still has to keep the promised goods ready for delivery, whether he can dispose of them in other profitable ways, or whether he can reduce his loss by making a cover transaction. Of course, termination does not preclude a claim for damages for non-performance (Art. 7.3.5 (2)). But it is this damages claim for non-performance that is supposed to place the innocent party, qua monetary compensation of his loss, in as nearly the same position as he would have been in if the contract had been performed.