



INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW  
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

---

**Working Group for the preparation of  
Principles of International Commercial Contracts (3rd)  
Drafting Committee  
Second session  
Hamburg, 2 – 5 March 2009**

UNIDROIT 2009  
Study L – WP.20  
English only  
January 2009

**Draft Chapter  
on  
Unwinding of Failed Contracts**

by

Professor Reinhard Zimmermann, Director at the Max-Planck-Institut für  
ausländisches und internationales Privatrecht, Hamburg



# **Unwinding of Failed Contracts**

## **I. Restitution following termination**

### **ARTICLE 1**

*(Contracts to be performed at one time)*

**(1) On termination of a contract to be performed at one time either party may claim restitution of whatever it has supplied under the contract, provided that such party concurrently makes restitution of whatever it has received under the contract.**

**(2) If restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable.**

**(3) The recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party.**

**(4) Compensation may be claimed for the necessary expenses linked to the performance received.**

#### **COMMENT**

##### **1. Contracts to be performed at one time**

The present article refers only to contracts to be performed at one time. A different regime applies to contracts to be performed over a period of time (see Art. 2). The most common example of a contract to be performed at one time is an ordinary contract of sale where the entire object of the sale has to be transferred at one particular moment. Instalment sales (i.e. contracts of sale where the purchase price is to be paid in instalments) therefore fall under the present article.

## **2. Entitlement of parties to restitution on termination**

Para. (1) of this article provides for a right for each party to claim the return of whatever it has supplied under the contract provided that it concurrently makes restitution of whatever it has received.

### **Illustration 1**

A sells a Constable painting to B for 2,000,000 Euro. B does not pay for the painting when it is delivered, and A therefore terminates the contract. A can claim back the painting.

The rule also applies when the aggrieved party has made a bad bargain. If, in the case mentioned in illustration 1, the true value of the painting is 3,000,000 Euro, A may still require the return of the painting.

The present article also applies to the situation where the aggrieved party has supplied money in exchange for property which it has not received or which is defective.

### **Illustration 2**

The Constable painting for which B has paid 2,000,000 Euro was not a Constable but a copy. On termination of the contract, B can claim back the money and must return the copy to A.

Concerning the costs involved in making restitution Art. 6.1.11 applies.

## **3. Restitution not possible or appropriate**

Restitution must normally be in kind. There are, however, instances where instead of restitution in kind, an allowance in money has to be made. This is the case first of all where restitution in kind is not possible. The allowance will normally amount to the value of the performance received for the recipient.

### **Illustration 3**

A who has contracted to clean the windows of B's business center, leaves it after only half of the windows have been cleaned. B, who then terminates the contract, will have to pay A a reasonable sum for the work done, measured by the value that work has for B.

An allowance is further envisaged by para. (2) of this article whenever restitution in kind would not be appropriate. This is so in particular when returning the performance in kind would cause unreasonable effort or expense. The standard, in that respect, is the same as under Art. 7.2.2(b).

#### Illustration 4

A, an artist, sells 200 silver-plated rings to B. Since A and B are friends, he sells them to B at less than their true value. B fails to pay for the rings and A thereupon terminates the contract. It turns out that B had, in the meantime, attempted to ship the rings to his business premises. However, the boat on which they had been stored, has sunk. Although it would be possible, at great expense, to rescue the rings from the wrecked ship, this cannot be expected of B. B has to pay a reasonable sum to A, measured by the value of the rings.

The purpose of specifying that an allowance has to be made in money “whenever reasonable” is to make it clear that an allowance only has to be made if, and to the extent that, the performance has conferred a benefit on its recipient. That is not the case, for example, where the defect which gives the recipient of the performance a right to terminate has only become apparent in the course of processing the object of that performance.

#### Illustration 5

A sells to B, who wants to paint his house, ten litres of paint. While B is using the paint it becomes apparent that it does not stick to the wall of the house. B can terminate and reclaim the purchase price but it would not be reasonable to expect him to make good the value of the paint.

### **4. The allocation of risk**

Obviously, the rule contained in para. (2) implies an allocation of risk: it imposes a liability on the recipient of the performance to make good the value of that performance if it is unable to make restitution in kind. The rule in para. (2) applies no matter whether the recipient has been responsible for the deterioration or destruction of what it had received. Such allocation of the risk of deterioration or destruction is justified, in particular, because there should be correspondence between risk and control. Of course, there is no liability to make good the

value where the deterioration or destruction is attributable to the other party: either because it has been due to the other party's fault, or due to a defect inherent in the performance.

#### Illustration 6

A sells and delivers to B a luxury car. The car has defective brakes; it therefore crashes into another car and is destroyed as a result of this accident. Since the car was unfit to be used for its intended purpose, B can terminate the contract and reclaim the purchase price. He does not have to make an allowance for not being able to return the car.

The recipient's liability to make good the value of the performance received is not excluded in cases where the deterioration or destruction would also have occurred had the performance not been rendered.

#### Illustration 7

A car has been sold and transferred to the purchaser; it is subsequently destroyed by a tornado flooding the properties of both the seller and the purchaser. The purchaser terminates the contract because of a defect attaching to the car. He can reclaim the purchase price but, at the same time, has to make an allowance for the value of the car.

Obviously, the question of risk allocation only arises in cases where the deterioration or destruction occurs *before* termination of the contract. If what has been performed deteriorates or is destroyed *after* termination of the contract, the normal rules on non-performance apply. For after termination, the recipient of the performance is under a duty to return what he had received. Any non-performance of that duty gives the other party a right to claim damages according to Art. 7.4.1, unless the non-performance is excused under Art. 7.1.7 (*force majeure*).

#### Illustration 8

A sells and delivers to B a limousine with a leaking roof. Since the limousine is unfit to be used for its intended purpose, B can terminate the contract. As a result, he can reclaim the purchase price but is under a duty to return the limousine. Before he can return the car it is destroyed by an accident resulting from the fact that it also had defective brakes. A cannot claim damages because B is excused under Art. 7.1.7.

## **5. Compensation for expenses linked to the performance**

The recipient of a performance may have incurred expenses for the maintenance of the object of the performance. It appears to be reasonable to allow him to claim compensation for such expenses in cases where the contract is unwound and where, therefore, the parties have to return what they have received.

### **Illustration 9**

A has sold and delivered a horse to B. Some time later it becomes apparent that the horse is not, as it was supposed to be, a descendant of a particular stallion. B terminates the contract. He can claim compensation for the costs that he has incurred in feeding the horse.

The rule applies only to necessary expenses (as in illustration 9). The Principles do not take a position as far as expenses are concerned that are merely useful or constitute a luxury. The Principles also do not take a position concerning fruits that have been derived from the performance, or interest that has been earned.

### **ARTICLE 2**

*(Contracts to be performed over a period of time)*

**On termination of a contract to be performed over a period of time restitution can only be claimed for the period after termination has taken effect, provided the contract is divisible.**

### **COMMENT**

#### **1. Contracts to be performed over a period of time**

Contracts to be performed over a period of time are at least as important, commercially, as contracts of sale where the object of the sale has to be transferred at one particular moment. They include complex equipment leases as well as many construction contracts, contracts for services, and agency contracts. The present rule also covers contracts of sale where the object of the sale has to be delivered in instalments. Performances under such contracts can have

been made over a long period of time before the contract is terminated, and it may thus be inconvenient to unravel these performances. Also, of course, termination is a remedy with merely prospective effect. Restitution can, therefore, only be claimed in respect of the period after termination.

#### Illustration 1

A contracts to service B's computer hardware and software for a period of five years. After three years of regular service A is obliged by illness to discontinue the services and the contract is terminated. B, who has paid A for the fourth year, can claim return of the advance payment for that year but not for the money paid for the three years of regular service.

Since the contract is terminated only *pro futuro*, any outstanding payments for part performances can still be claimed. Art. 2 also, of course, does not prevent a claim for damages being brought.

#### Illustration 2

A leases equipment to B for three years at a rental of 10,000 Euro 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 Euro already received (Art. 2) and to recover the 30,000 Euro accrued due (on the basis of the contract of lease which is terminated only *pro futuro*), together with damages for the present value of the future rentals (Art. 7.3.5 (2) PICC).

#### Illustration 3

O engages company 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 his contract with C. O is entitled to retain the benefit of the work performed so far (Art. 2), to have it 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) and to recover any additional



costs thereby incurred, together with damages for any delay (Art. 7.4.1 in conjunction with Art. 7.3.5 (2) PICC). C is entitled to retain the 7 million Euro it has received (Art. 2) and to be paid the 1 million Euro it is still owed (this is based on the original contract which has only been terminated *pro futuro*).

#### Illustration 4

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 that it cannot continue with the cleaning services unless the price is doubled. H refuses to agree and C ceases to provide the service. On terminating the contract H can recover damages for any additional expense it incurs in hiring another cleaning firm (Art. 7.4.1 in conjunction with Art. 7.3.5 (2) PICC), while C is entitled to retain the payments it has received for services already provided (Art. 2).

The rule that restitution can only be claimed for the period after termination has taken effect does not apply if the contract is indivisible.

#### Illustration 5

A undertakes to paint ten pictures depicting one and the same historical event for B's festival hall. After delivering and having been paid for five paintings, A abandons the work. In view of the fact that the decoration of the hall is supposed to consist of ten paintings to be painted by the same painter and showing different aspects of one historical event, B can claim return of the advances paid to A and must return the five paintings to A.

## **I. Restitution following avoidance**

### **ARTICLE 3**

*(Restitution following avoidance)*

**(1) On avoidance either party may claim restitution of whatever it has supplied under the contract, or the part of it avoided, provided that such party concurrently makes restitution of whatever it has received under the contract, or the part of it avoided.**

**(2) If restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable.**

**(3) The recipient of the performance does not have to make an allowance in money if the impossibility to make restitution in kind is attributable to the other party.**

**(4) Compensation may be claimed for the necessary expenses linked to the performance received.**

#### **COMMENT**

##### **1. Entitlement of parties to restitution on avoidance**

According to para. (1) of the present article either party may claim restitution of what it has supplied under the contract or the part of it avoided. The only condition for such restitution is that each party makes restitution of whatever it has received under the contract or the part of it avoided.

##### **Illustration 1**

A sells and transfers a painting to B for 2,000,000 Euro. He has made B believe that it is a Constable whereas in reality it is a cheap copy. After he has discovered that B avoids the contract. B can claim back the purchase price of 2,000,000 Euro while himself having to return the painting that he has received.

Concerning the costs involved in making restitution Art. 6.1.11 applies.

## **2. Restitution not possible or appropriate**

Restitution must normally be in kind. There are, however, instances where instead of restitution in kind, an allowance in money has to be made. This is the case first of all where restitution in kind is not possible. The allowance will normally amount to the value of the performance received for the recipient.

### **Illustration 2**

A commissions B to paint his house. B had fraudulently induced A to conclude the contract at a price that is much higher than the market price. After having discovered the fraud, A avoids the contract. He can claim back the price demanded by B while himself being under a duty to pay for the value of having had his house painted.

An allowance is further envisaged by para. (2) of this article whenever restitution in kind would not be appropriate. This is so in particular when returning the performance in kind would cause unreasonable effort or expense. The standard, in that respect, is the same as under Art. 7.2.2(b).

### **Illustration 3**

A fraudulently induces B to buy 100 barrels of oil. The oil is reloaded onto one of B's ships. In a heavy storm that ship sinks in coastal waters. When B has discovered the fraud, he terminates the contract. He can recover the price that he has paid, while himself having to make an allowance representing the value of the oil in view of the fact that recovery of the oil from the sunk ship would involve him in expenses vastly exceeding the value of the oil.

The purpose of specifying that an allowance has to be made in money "whenever reasonable" is to make it clear that an allowance only has to be made if, and to the extent that, the performance received has conferred a benefit on the party claiming restitution.

### **Illustration 4**

A has undertaken to decorate the entrance hall of B's business centre. After he has completed about half of the decorations B discovers that A is not the well-known decorator who he has held himself out to be. B avoids the contract. Since the

decorations so far made cannot be returned, and have no value for B, A is not entitled to any allowance for the work done.

### **3. The allocation of risk**

Obviously, the rule contained in para. (2) implies an allocation of risk: it imposes a liability on the recipient of the performance to make good the value of that performance if it is unable to make restitution in kind. The rule in para. (2) applies no matter whether the recipient has been responsible for the deterioration or destruction of what it had received. Such allocation of the risk of deterioration or destruction is justified, in particular, because there should be correspondence between risk and control. Of course, there is no liability to make good the value where the deterioration or destruction is attributable to the other party: either because it has been due to the other party's fault, or due to a defect inherent in the performance.

#### **Illustration 5**

A fraudulently induces B to buy a luxury car that is defective. As a result of the defect the car is destroyed. B can rescind the contract on the ground of fraud. He can claim back the purchase price but does not have to make good the value of the car.

The recipient's liability to make good the value of the performance received is not excluded in cases where the deterioration or destruction would also have occurred had the performance not been rendered.

#### **Illustration 6**

A luxury car has been sold and transferred to the purchaser; it is subsequently destroyed by a tornado flooding the properties of both the seller and the purchaser. The purchaser avoids the contract because of a relevant mistake. He can reclaim the purchase price but, at the same time, has to make an allowance for the value of the car.

Nor is the recipient's liability to make good the value of the performance excluded in cases where he has been led to conclude the contract by the other party's fraudulent representation.

#### **Illustration 7**

The antique dealer A has fraudulently induced the garage owner B to swap A's ramshackle car against a valuable ancient Greek vase belonging to B. The car is

accidentally destroyed while standing in B's garage. If B rescinds the contract, he can claim the vase back but has to make good the value of the car.

Art. 3.8 PICC (fraud) merely wants to make sure that B is not bound by the contract that he has entered into: that is why a right of avoidance is given to him; and to make sure that B is not saddled with the consequences of a bad bargain that A has induced him to make: that is why there has to be restitution. But the rule on fraud does not intend to protect B against accidents. It is not the substitute for an insurance policy.

#### **4. Compensation for expenses linked to the performance**

The recipient of a performance may have incurred expenses for the maintenance of the object of the performance. It appears to be reasonable to allow him to claim compensation for such expenses in cases where the contract is unwound and where, therefore, the parties have to return what they have received.

##### **Illustration 8**

A has sold and delivered a horse to B. After some time B realizes that A has fraudulently concealed from him the true parentage of that horse. B avoids the contract. He can claim compensation for the costs that he has incurred in feeding the horse.

This rule applies only to necessary expenses (as in illustration 8). The Principles do not take a position as far as expenses are concerned that are merely useful or constitute a luxury. The Principles also do not take a position concerning fruits that have been derived from the performance, or interest that has been earned.

## **Appendix A**

### **Examples provided by Gabriel and Raeschke-Kessler**

A bridge crossing a river had been ordered as “turn key” by the public highway authority and had been  $\frac{3}{4}$  completed by the company. The highway authority then changed its routing leaving the bridge without roads it could connect. The authority therefore stopped its instalment payments, leading to a termination of the contract by the company, 25 % of the price being paid.

The  $\frac{3}{4}$  completed bridge has no “value” whatsoever.

The company may claim compensation under Art. 1(2) related to the work performed.

Comment by RZ: In my view this is a contract to be performed over a period of time (see also Furmston and Goode in Summary Records, n. 77). As a result, Art. 2 applies. But the contract is not divisible. This is why both parties can claim restitution under Art. 1 (1). Since restitution in kind of the bridge is not possible, an allowance has to be made. Here it would not appear to be reasonable to use the value of the performance received for the recipient as yardstick for measuring the allowance, for the fact that the  $\frac{3}{4}$  completed bridge has no value for the recipient is due to the recipient’s decision to change the routes of the highway. The allowance should reflect the value of the investment made by the company.