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Item No. 4 on the agenda: International Commercial Contracts –

(b) Possible future work on long-term contracts

(Memorandum prepared by the Secretariat)

Summary	*Proposal for future work on long-term contracts*
Action to be taken	*See paragraph 15*
Mandate	*Future Work Programme*
Priority level	*Medium*
Related documents	*UNIDROIT 2013 – C.D. (92) 4 (b)*

1. The UNIDROIT Principles of International Commercial Contracts (hereinafter "UNIDROIT Principles") – first published in 1994, followed by a second enlarged edition in 2004 and now in their third 2010 edition – represent a non-binding codification or "restatement" of the general part of international contract law. In their current edition of 211 articles divided into 11 chapters – as compared to the 185 articles of the 2004 edition and the 120 of the first edition – they cover virtually all the most important topics of general contract law, such as formation, interpretation, validity, performance, non-performance and remedies, assignment, set-off, limitation periods, etc. In view of their comprehensive nature the UNIDROIT Principles, whose main source of inspiration has been the U.N. Convention on Contracts for the International Sale of Goods (CISG), has been described as a sort of "general part" of international sales law. However, in actual practice, while it is true that the UNIDROIT Principles have been applied by courts and arbitral tribunals mainly with respect to sales contracts and other contracts to be performed at one time, there is an increasing number of decisions relating to long-term contracts such as distributorship, licensing, contractual joint ventures, etc., and to investment contracts such as exploration and exploitation agreements, BOT concession agreements, etc. Although most of them are arbitral awards and as such remain confidential, the UNILEX database contains no fewer than forty decisions relating to long-term and investment contracts: in some cases, the UNIDROIT Principles have been chosen by the parties as

the law governing the contract, but more frequently they have been applied by the arbitral tribunal on its own motion as an expression of "general principles of law", "lex mercatoria" or the like, referred to in the contract as the applicable law.

2. What still remains to be seen is to what extent the UNIDROIT Principles provide adequate solutions also for long-term contracts in general and investment contracts in particular, all the more so since, for these types of contract, there is no international uniform law instrument comparable to the CISG and the main legal sources are – apart from domestic laws and in the case of investment contracts, the BITs – the individual agreements which, lengthy and detailed as they may be, by their very nature focus on topics peculiar to the particular transaction involved while normally neglecting matters of general contract law.

3. The UNIDROIT Principles as they now stand already contain a number of provisions which meet the special needs of long-term contracts in general, and investment contracts in particular. Suffice it to mention Article 2.1.14 which, by stating that, if the parties intend to conclude a contract, the fact that they intentionally leave a term to be agreed upon in further negotiations or to be determined by a third person does not prevent the contract from coming into existence, is particularly suited to these types of contract where the parties, on account of the duration of the contract and/or the complexity of the subject, often leave open one or more terms because they are unable or unwilling to determine them at the time of conclusion of the contract. Likewise, Articles 5.1.4, distinguishing between the duty to achieve a specific result and the duty of best efforts, and Article 5.1.5, providing criteria for determining whether the parties are under one or the other duty, take into account the fact that throughout their duration, long-term contracts in general, and investment contracts in particular not only give rise to a great variety of obligations for the two or more parties involved, but the degree of diligence required in performing these obligations varies considerably from one obligation to another. Moreover, also Articles 6.2.2 and 6.2.3 on hardship take into account the fact that long-term contracts in general, and investment contracts in particular, are for a variety of reasons particularly exposed to the consequences of supervening unforeseeable events which may substantially alter the equilibrium of the contract as originally agreed upon between the parties, thereby requiring renegotiation and ultimately adaptation of the contract so as to restore the original equilibrium.

4. On the other hand, there can be no doubt that there are still issues particularly relevant in the context of long-term contracts in general, and investment contracts in particular, which the UNIDROIT Principles in their present form do not address at all or do so insufficiently.

5. By way of example, in view of their complexity, long-term contracts in general, and investment contracts in particular, are often concluded after prolonged negotiations without an identifiable sequence of offer and acceptance, with the consequence that it may be difficult to determine whether and, if so, when a binding agreement has been reached. The UNIDROIT Principles address both questions, but do so only in general terms. Thus Article 2.1.1 provides that "[a] contract may be concluded either by the acceptance of an offer or *by conduct of the parties that is sufficient to show agreement*" (emphasis added). On its part, the Official Comment to Article 5.3.1 refers to the so-called closing procedure parties may provide for when negotiating complex and high-value transactions, and which consists of the formal acknowledgment ("closing") at a certain point in time ("closing date") that on or before that date all the stipulated conditions ("conditions precedent") have been satisfied. However, what if, because of the complex nature of the transaction, negotiations proceed in stages and the agreement is reached only bit by bit, with the parties exchanging writings known by a variety of names, such as "letters of intent", "agreements in principle", "memoranda of understanding", "heads of agreement" etc.? All these writings have in common that they do not represent the ultimate agreement in its entirety, but their precise nature and legal effects are far from clear (a simple indication of one party's intention to open negotiations

with the other party with a view to reaching an agreement on particular issues with no further commitment on its part?, a so-called preliminary contract, i.e., a binding agreement between the parties to conclude, at a later stage, a contract with the terms already agreed upon?, etc.). Likewise, what if, in the course of the negotiations, the parties sign an informal document, usually called "Preliminary agreement", containing the terms of the agreement so far reached, but at the same time declare their intention to provide for the execution of a formal document at a later stage, by including language such as "Subject to contract" or "Formal agreement to follow". Statements of this kind are certainly admissible under the UNIDROIT Principles, as the parties may well derogate from the general principle laid down in Article 1.2, according to which the conclusion of a contract is not subject to any requirement as to form. The problems which they pose lie elsewhere. First of all, is the envisaged formality constitutive or not, i.e. did the parties intend to condition the conclusion of the contract on the execution of the formal document, or did they instead want the formality simply for evidentiary purposes? In addition, if the special formal requirement is intended to be of a constitutive nature, may it be waived by the subsequent conduct of the parties?

6. Furthermore, Article 2.1.14, providing that where parties intentionally leave a term to be agreed upon in further negotiations or to be determined by a third person, the existence of the contract is not affected by the fact that subsequently the parties reach no agreement or the third person does not determine the term if there is a reasonable alternative means of rendering the term definite, may need to be further expanded for the case where the parties envisage the intervention by a third person. In particular, does that person have to be an independent expert or can he/she be an expert connected with one of the parties (e.g., an engineer of the employer in construction contracts)? And who is to appoint the third person if the parties fail to reach an agreement on his/her appointment? Finally, can the determination by the third person be challenged by one of the parties, and if so on what grounds?

7. Again, Article 2.1.15, setting out in general terms the parties' duty to negotiate in good faith – *rectius*: not to negotiate in bad faith –, would seem to need additional specification with respect to long-term contracts in general, and investment contracts in particular, which are normally the result of prolonged negotiations and may also in the course of their performance on a number of occasions require (re-)negotiations. In order to provide further guidance to parties and, in case of dispute, to courts and arbitral tribunals, one could think of indicating in greater detail what specific duties the general duty to (re-)negotiate in good faith involves, for instance to make a serious effort to reach agreement, to produce all relevant information, to make concrete suggestions for a possible agreement instead of mere general declarations of willingness, to obtain expert advice in complex consensus proceedings, to avoid unnecessary delays in the consensus proceedings, etc.

8. Yet also with respect to the consequences of negotiating in bad faith, the UNIDROIT Principles merely state that "[…] a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party" (Article 2.1.15(2)), with the Official Comment specifying that "[…] the aggrieved party may recover the expenses incurred in the negotiations and may also be compensated for the lost opportunity to conclude another contract with a third person […]" and that "[o]nly if the parties have expressly agreed on a duty to negotiate in good faith, will all the remedies for breach of contract be available to them, including the remedy of the right of performance". In view of the considerable practical importance of the issue, especially in the context of long-term contracts in general, and investment contracts in particular, it may be advisable to address it in more detail, distinguishing between the remedies in case of breach of the general duty to negotiate in good faith and those in case of breach of a contractually agreed duty to negotiate in good faith.

9. Likewise, since long-term contracts are by their very nature "evolutionary", i.e., the parties' obligations cannot be fully determined in advance, Article 5.1.1, providing that the parties' obligations are not limited to those expressly stipulated in the contract but may also be implied, may need further elaboration. It is true that Article 5.1.2, by stating that "[i]mplied obligations stem from (a) the nature and purpose of the contract; (b) practices established between the parties and usages; (c) good faith and fair dealing; (d) reasonableness", provides a first indication as to the sources of implied obligations. However, with respect to long-term contracts in general and investment contracts in particular, more details would definitely be required, especially with respect to lit. a), i.e., implied obligations stemming from the nature and purpose of this kind of contract.

10. The same can be said, *mutatis mutandis*, of Article 5.1.3 which states only in general terms the parties' duty of cooperation and may therefore need further elaboration in view of the fact that the duty of cooperation in the course of the contract performance is particularly relevant in the context of long-term or so-called "relational" contracts. Suffice it to mention that in contracts of this kind a party, apart from being under the duty not to hinder the other party's performance, may often even have a duty of active cooperation, in which case additional questions arise such as the allocation of the costs of such cooperation.

11. The UNIDROIT Principles grant the disadvantaged party the right to request renegotiations only in case of hardship (Article 6.2.3), while in case of force majeure the party affected by the supervening impediment may only invoke it as an exception with a view to its non-performance being excused (Article 7.1.7). With respect to long-term contracts in general, and investment contracts in particular, where normally neither party would have an interest in terminating a relationship which may have endured for years and/or involved large investment, it may be argued that also in case of force majeure both parties should be requested to engage in renegotiations with a view to adapting the contract to the new situation before resorting to other remedies such as withholding performance or termination of the contract.

12. Though rather rare, there are cases where the duration of long-term contracts in general, and investment contracts in particular, the duration of which is neither determined nor determinable, or where the parties have stipulated that their contract is concluded for an indefinite period. For all these cases, Article 5.1.8 provides that the contract may be ended by either party by giving notice a reasonable time in advance: yet granting the parties such a unilateral right to put an end to the contract may not be sufficient and it may be advisable to provide, analogously to Article 7.3.7, that once the contract has been ended restitution for past performances is excluded.

13. More importantly, the UNIDROIT Principles do not address the question as to whether, and if so to what extent, parties to long-term contracts are entitled, even in the absence of any special provision to this effect in the contract, to terminate their contract for irreparable breakdown of their mutual trust and confidence (so-called "termination for cause"). Long-term contracts are typically so-called "relational contracts", i.e., contracts giving rise to a more or less enduring relationship based on trust and confidence between the parties and an ongoing duty to cooperate so as to allow each party properly to perform its obligations. As a consequence, such contracts are subject not only to the usual risks of a breach by one of the parties or of supervening events making performance impossible or excessively more onerous, but also to the risk of an irreparable breakdown of the parties' mutual trust and confidence, making the continuation of their relationship, at least for one of the parties, no longer sustainable. Of course, when entering into long-term contracts of this kind, the parties are well advised to address the issue, and indeed in actual practice frequently do so, by so-called termination clauses defining the contingencies in which the contract may be terminated for this reason and specifying how the right to terminate may be exercised (e.g., by mere notice to the other party or by a court decision), whether termination takes effect immediately or only after a certain period of time, whether the terminating

party or the other party is entitled to damages, etc. However, a problem arises when the contract is silent on this issue and it may be argued that the UNIDROIT Principles, like a number of domestic legislations (e.g., § 314 of the German Civil Code (as amended in 2001)) should include default rules on so-called termination of long-term contracts for cause.

14. Last but not least, investment contracts pose a number of special problems if, as is often the case, they are so-called "State contracts", i.e., stipulated between private investors and the Government or a governmental agency of the host State. The most controversial issues relate to supervening changes in the laws of the host country which negatively affect the foreign investment. Investment contracts normally contain so-called stabilisation clauses, i.e., provisions that either preclude the application of, or require compensation for, new or changed regulatory measures affecting the investment, or so-called adaptation clauses, i.e., provisions which, in case of supervening changes in the applicable law, grant the foreign investor the right to request renegotiations to adapt the contract to the new situation. What still remains to be seen is whether such safeguards in investment contracts (and possibly reinforced in the BIT concluded between the host State and the foreign investor's home State) operate also with respect to regulatory measures enacted for legitimate public objectives, such as public health, safety, the environment and – particularly important in the agricultural sector – food and water shortages. And indeed, it may be argued that the host State, at least in extreme emergency cases, may have a legitimate interest to invoke the force majeure exception so as to exclude any liability on its part. Alternatively, the host State may be entitled to apply by analogy the provisions to be found in many BITs allowing restrictions on the export of foreign capital in case of economic or fiscal crisis, or the suspension of the obligations under the treaty in the interests of national security. In any case, it may be appropriate to provide that, whenever the host State enacts such emergency measures, parties should enter into negotiations in good faith in order to achieve a mutually acceptable solution.

15. If the Governing Council were to decide to start work on long-term contracts in general, and investment contracts in particular, one could envisage three alternative approaches. One would be to proceed to a close examination of both the black letter rules and comments of the present edition of the UNIDROIT Principles with a view to determining the modifications/additions, if any, to be made in order to take into account the special needs of long-term contracts in general, and investment contracts in particular. Another approach would be to prepare a kind of supplement to the current edition of the UNIDROIT Principles, i.e., a separate publication containing black letter rules and comments specifically addressing issues of relevance in the context of long-term contracts in general, and investment contracts in particular. Finally, one could envisage the preparation of a "Legal Guide to the Use of the UNIDROIT Principles of International Commercial Contracts 2010 in Long-term Contracts & Investment Contracts" indicating how parties may, in their contract, adapt or supplement the black letter rules of the present version of the UNIDROIT Principles to meet the special needs of long-term contracts in general, and investment contracts in particular.