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Position Paper
on
Unwinding of Failed Contracts

by

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1. I have been asked to prepare a position paper on the unwinding of failed contracts. A contract can fail **for a number of reasons**. The two most important ones, according to PICC are (i) avoidance in cases of mistake, fraud, threat, or gross disparity (Arts. 3.5, 3.8, 3.9, 3.10) and (ii) termination in case of fundamental non-performance (Art. 7.3.1). But there are also other reasons, i.e. (iii) hardship (Art. 6.2.3, provided the parties do not reach agreement in their attempt to renegotiate the contract), and (iv) failure to reach agreement (e.g. in the situation envisaged in Art. 2.1.13). (v) Invalidity as a result of illegality is not yet covered by PICC but rules will be drafted by the present Working Group. (vi) A contract can also have failed to materialize upon the fulfilment of a resolutive condition. Again, this is a situation that is not covered by PICC as they stand today but that will have to be looked at by the present Working Group.

2. The task of this position paper cannot be to reinvestigate the **reasons** why a contract can fail. The rules that have been laid down in the existing PICC, and that will be drafted by the present Working Group, will thus simply be accepted. It will also be taken for granted that, when a contract has failed, the parties cannot claim performance under it. That is expressly stated in Art. 7.3.5 and taken for granted in Arts. 3.17 and 6.2.3 (4)(a). This paper will, therefore, merely look at the **consequences** of a failure of contract if that contract has already been acted on by the parties. It is only then that it makes sense to refer to the “unwinding” of a contract.

3. At present, PICC contain two rules dealing with that situation. They deal with the consequences of **avoidance** (Art. 3.17) and **termination** (Art. 7.3.6). The task of the present paper must therefore be to reassess these rules and to ask to what extent and in which way they need to be amended. We will start our investigation with Art. 3.17 PICC.

4. According to Art. 3.17 (1) PICC **avoidance** takes effect retroactively. That means, as the Official Comment explains, that the contract is considered never to have existed. If, therefore, something has been performed under the contract, it has been performed without legal ground. That means that it has to be **returned**. This is why Art. 3.17 (2) states that

"on avoidance either party may claim restitution of whatever it has supplied under the contract". That rule should be retained.

5. In many cases both parties will have supplied what they had promised under the contract. Here it would obviously be unjust to require only one of the parties to make restitution; or to require the one to make restitution before the other has done so. Both parties have to render restitution **concurrently**. That is stated in Art. 3.17 (2) and, again, that is as it should be. The rule mirrors the way in which the obligations under a valid contract have to be performed.

6. Restoration has to be **in kind**. That is the rule envisaged in Art. 3.17 (2), and it also deserves to be supported. The alternative would be to allow the purchaser to make good the value of the object received. But then the position would not be as if the contract had never existed. The seller would effectively be forced to sell his object in spite of the fact that the contract is invalid. That cannot be right.

7. In certain situations, **in the nature of things**, restitution in kind is **impossible**. A typical example are services that have been rendered under the contract that turns out to be void. For these situations Art. 3.17 (PICC) states that the recipient must "make an allowance for what it has received". It is unclear what "an allowance" means or how it has to be calculated. The Official Comments do not clarify the issue. (Art. 4:115 PECL, in the same context, determines that "a reasonable sum" must be paid for what has been received.) It is submitted that the matter should be clarified by providing that where restitution in kind cannot be made, the value of what has been performed must be made good.

8. The real question can only be whether it should be the objective value (i.e. the **market value**) or the value of the performance for the specific recipient. Art. 3.17 PICC, so far, supports the second view. That is demonstrated by the illustration: "A commissions B to decorate a restaurant. B begins the work. When A later discovers that B is not the famous decorator who had made similar decorations in a number of other restaurants, A avoids the contract. Since the decorations so far made cannot be returned and they have no value for A, B is not entitled to any allowance from A for the work done." It is probably in order to accommodate this type of situation that the imprecise term "allowance" has been chosen. No reason is given why it should be right that B loses all. If we assume that B has fraudulently induced A to conclude the contract, the reason appears to be clear: If B were

now allowed to claim the objective value of his services, he would effectively be able to force a contract concerning his services upon A. That would undermine the policy pursued by Art. 3.9: A is to be protected from the effects of B's fraudulent behaviour. On the other hand, however, the PICC clearly contain a mechanism which is designed to protect A in this type of situation. For according to Art. 3.18, the party who knew or ought to have known of the ground for avoidance is liable for damages "so as to put the other party in the same position in which it would have been if it had not concluded the contract". If A would not have concluded the contract, he would not have the decorations made by B on his wall. Nor would he have had to pay for them. **Qua damages**, therefore, A can ask B to be relieved from his obligation to pay for the decorations; and he can ask B to undo them, i.e. to see to it that the wall of his restaurant is restored to its former position. It is submitted that, under these circumstances, it is unnecessary to introduce another layer of protection concerning the innocent A into the PICC. The measure for assessing compensation in cases where restitution in kind is not possible because of the nature of what has been received should therefore always be the **market value**. Since the duty to make good the value takes the place of restitution in kind, and is supposed to place the party entitled to demand restitution in the same position in which he would have been, had it been possible to make restitution in kind, it is submitted that the market value at the moment when restitution in kind becomes impossible is relevant. That may be stated in the Official Comment.

9. It can take some time before the contract is avoided. In the meantime, both parties have often derived some **benefit** from whatever they have received: the purchaser has used the car that was transferred to him, and the seller has invested the sum of money he has received as purchase price. When the contract is rescinded, restitution also has to cover these benefits. Since he has held, whatever he has received under the contract, without legal ground, he has also derived these benefits without legal ground. As a rule, restitution in kind is impossible. Therefore, the value of the benefits has to be returned. The concept of "benefits" includes the fruits of an object (both the natural fruits and the proceeds supplied by an object or a right by virtue of a legal relationship) and the advantage of being able to use an object; see the commentaries to Art. 84 CISG.

10. If we now turn out attention to restitution after **termination** for fundamental non-performance, we find in Art. 7.3.6 (1) a regulation which is largely identical with Art. 3.17 (2). This is the case in spite of the fact that termination does not lead to a

situation where the contract is treated as never having been made. Of course, both parties are released from their obligations to effect performance. But they can still rely on arbitration clauses contained in the contract, or on any other contractual term which was intended to operate after termination. Also, termination does not preclude a claim for damages for non-performance. To some extent, therefore, the contract continues to be effective. Some legal systems attempt to rationalize this by saying that the contract undergoes a transformation. It no longer aims at implementing what was contractually agreed upon; instead, it aims at unwinding the relationship between the parties.

11. If, then, upon termination the relationship between the parties is to be "unwound", it follows that the parties should not be allowed to keep what they have received under the contract. That is why Art. 7.3.6 (1) states that upon termination of the contract either party may claim **restitution** of whatever it has supplied. That rule is identical with the one laid down in Art. 3.17 (2). Art. 7.3.6 (1) further provides that if a party claims restitution of what it has supplied, it concurrently has to make restitution of what it has received. Again, that is identical with Art. 3.17 (2); in both cases it mirrors the contractual synallagma on the level of the law of restitution. The third rule laid down in Art. 3.17 (2) also finds its parallel in Art. 7.3.6 (1): if restitution in kind is impossible, "an allowance" in money has to be made. In this case, however, the two rules are not identical. (i) Art. 7.3.6 (2) specifically states that the "allowance" has to be made in money, Art. 3.17 merely refers to an "allowance". But also in the latter situation it must be taken for granted that the allowance has to consist in a sum of money. (ii) Under Art. 7.3.6 (1) an allowance not only has to be made if restitution in kind is not possible but also if it is "**not appropriate**". According to the Official Comment, this addition is supposed, in particular, to cover cases where the aggrieved party has received part of the performance and wants to retain that part. It is not clear to me what that means. If the professional mountaineer B has bought mountaineering kit from A and the harness is defective while the crampons and the ice-axe are not, he should terminate the contract with regard to the harness only if he wishes to keep the crampons and the ice-axe. Restitution of the harness, under these circumstances, is neither impossible nor inappropriate. (iii) According to Art. 7.3.6 (1) allowance should be made in money "**whenever reasonable**". That qualification is lacking in Art. 3.17 (2). The Official Comment 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. The phrase “whenever reasonable” is thus intended to bring out a point that is taken to be implicit in Art. 3.17 (2). The result in both situations is the same, and rightly so. The qualification “whenever reasonable” does not, therefore, constitute a substantive difference between the two restitution regimes.

12. There is one other difference between Art. 3.17 (2) and Art. 7.3.6 (1) that has not been touched upon, so far. Art. 3.17 specifically refers to the situation that only **part of the contract** may be avoided (see Art. 3.16); restitution may then, of course, only be claimed with respect to the part of the contract that has been avoided. Art. 7.3.6 (1), on the contrary, does not refer to the situation that only part of a contract has been terminated. That situation is only envisaged in the Official Comment (see above, sub 11). In fact, just as a contract can only be partly avoided, it can only partly be terminated. That is the case, in particular, if one party delivers only a part of the goods or if only a part of the goods delivered is in conformity with the contract (see Art. 51 CISG). It can be taken for granted that, under those circumstances, restitution may only be claimed under the part of the contract that has been terminated. It may be advisable to amend Art. 7.3.6 (1) accordingly; alternatively, it may be advisable to delete the words “or the part of it avoided” from Art. 3.17 as being self-evident. At any rate, once again, there is no difference between the two regimes.

13. If it appears advisable under Art. 3.17 to specify what has to be returned when restitution in kind, in the **nature of things**, is **impossible**, the same is true under Art. 7.3.6 (1). Again, the recipient has to return the value of the performance in money.

14. Once again, also, the question must be asked whether the value must be assessed objectively (market value), or subjectively (value of the performance for the specific recipient). The Official Comment to Art. 7.36 provides the following illustration: B, who has undertaken to decorate a bedroom suite for A, a furniture maker, abandons the work after having completed about half of the decorations. A can claim back the advance payments, but as the decorations have no value for A, A does not have to pay for the work which has been done. – However, even if one were to assess the **value objectively**, the result would be the same. On the other hand, it may be argued that there does not appear to be a market value for decorating one half of a bedroom suite. On the other hand, even if one were to put a market value on decorating half a bedroom suite, A would still be allowed to claim damages (Art. 7.3.5 (2) in conjunction with Arts. 7.4.1 and 7.4.2): A is

entitled to full compensation for harm sustained as a result of the non-performance. If A decides to get the decorations completed by someone else, he may have incurred losses as a result of the decorations having been completed later than envisaged, or more expensively than if they had been done by B. He can claim these losses from B. But it would be wrong, under these circumstances, to deny him a claim for the (objective) value of the work done to B. If, on the other hand, A has to ask another decorator (c) to redecorate the entire room (i.e. to remove the decorations made by B), he can claim from B whatever he has had to pay in addition to the sum originally bargained for. If the sum originally agreed upon with B was 100, and he now has to pay 110 to C, A can ask B to be relieved from the obligation to make good the value of the decorations made by B and, in addition, claim 10.

15. Just as Art. 3.17 (2) should be amended to grant a right of restitution not only concerning the performance but also concerning the **benefits** derived, Art. 7.3.6 (1) should be amended accordingly. These benefits may not have been derived without legal ground in the technical sense of that phrase; for the situation is not to be treated as if the contract had never been made. Still, however, the contract has to be "unwound". The seller should never have received the (full) purchase price for the defective car delivered by him and he should not, therefore, have been in a position to invest it. This intuition is confirmed by Art. 84 CISG.

16. It sometimes happens that one of the parties fails to derive the benefits from what has been supplied to him under the contract: he does not invest the purchase price; or he does not use the car that he has bought. The question then arises whether the law should effectively recognize a duty to derive benefits in accordance with the principle of ordinary business practice by imposing a liability on the recipient of the performance to make good the value of benefits that he has failed to derive from the performance. The problem is not dealt with in the provisions of CISG and is, consequently, disputed. Arguably, an obligation to make good the value of the **benefits** a party to the contract has **failed to derive** from the performance is alien to what termination of the contract is supposed to achieve, i.e. to place the parties in the situation in which they would have been, had the performances not been exchanged. Matters may be different in situations where the recipient knew or ought to have known the reason why the contract was to be unwound. That is a scenario easily envisageable in cases of avoidance (fraud, threat), but it can also

happen in cases of termination (the seller has delivered an object which he knew to be severely defective).

17. The great substantive question to be settled with regard to both termination and avoidance is: what happens if one of the parties is unable to return the performance received by him because what he has received has deteriorated or has been destroyed? We will look at that question first in the context of termination. The paradigm example is the defective car, or motor truck, that has been bought and transferred to the purchaser and that is subsequently destroyed or seriously damaged in a road accident, or while standing on the parking place of the purchaser's factory. The problem, obviously, is one of **risk allocation**, and it raises two questions. How is the risk of destruction or deterioration to be allocated? And which device is to be used in order to effect whatever risk allocation is regarded as equitable?

18. Discussion of the first question has, for a long time, been overshadowed by the heritage of Roman law. *Mortuus redhibitur* is the famous tag extracted from the sources. It is a fiction with which the Roman jurists operated in cases of restitution under the *actio redhibitoria*. The situation had to be treated **as if** the purchaser had been able to return the (living) slave or animal. On that supposition, however, he was able to claim back his purchase price even though the slave had in fact died and could not be returned. Effectively, therefore, the risk that the object of the sale has perished was placed on the shoulders of the seller. The question why the Roman lawyers employed this fiction, and with it the risk regime just mentioned, has not yet found a satisfactory answer. None the less, it was perpetuated, in a generalized form, in some of the modern civil codes. German law before the reform legislation of 2002 provides an example. The respective rule has become one of the most vehemently criticized individual rules in the (old) German law of obligations.

19. If one attempts to assess the substantive arguments that have been advanced over the years in favor of the one or other solution to the problem, one finds a number of authors focusing on the **will of the parties** to the contract. The parties, however, have not normally contemplated the consequences of a failure of their contract. Thus, it is really the presumed intention of the parties that provides the starting point for an argument one way or the other. But the presumed intention of the parties is, all too often, merely a matter of speculation; and thus it is hardly surprising that both imagineable risk regimes have been

based on it. The allocation of risk is a normative question which should not be hidden behind the façade of the presumed intention of the parties.

20. Reliance does not appear to be a suitable criterion either. Of course, it may be argued that, having received performance, the purchaser relies on being able to keep that performance; and that reliance includes an awareness that he has lost his own (counter-)performance. But can he reasonably rely on being able to claim back the purchase price if it turns out that the car that has been delivered turns out to be defective and has been destroyed accidentally? Whether the question is answered positively or negatively depends, once again, on normative considerations which should not be hidden behind a convenient label.

21. Sometimes it is said that risk allocation has to follow the rule: *res perit domino (casum sentit dominus)*. Whether the seller or the purchaser has to bear the risk of accidental destruction would then depend on whether or not **ownership** has passed. The position would thus be different according to whether ownership passes on conclusion of the contract of sale, or only when the object that has been sold is handed over to the purchaser. That question, however, has not yet been determined by the PICC. Thus, it would appear to be unwise in the present context to focus on the question of legal title. It would be better to devise a system-neutral criterion.

22. Sometimes, **equitable doctrines** such as "he who seeks equity must do equity", or the *exceptio doli*, have been referred to in the present context. But while they can indeed be resorted to in order to substantiate the rule that, whoever claims restitution of what he has supplied, also has to make restitution of what he has received, if he is able to do so, they tell us nothing about the situation when he is unable to make restitution himself. For whether it is inequitable for him, under these circumstances, to claim restitution of what he has supplied, is the very question that needs to be answered first. Resort to the equitable maxims would beg that question.

23. The most convincing criterion to determine the issue of risk allocation would appear to be the correspondence between **risk and control**. After delivery, the object of the sale is in the purchaser's sphere of influence and control. He has the advantage of being able to use the object and, as a corollary, also has to carry the risk. To that extent, the situation does not change as a result of termination of the contract: the object has been, and continues to

be, in the purchaser's sphere and thus there is no reason why the risk should be allowed to jump back to the seller. In addition it may be pointed out that it is only the recipient of a performance, who has the possibility of taking out **insurance** concerning the risk of accidental destruction or deterioration.

24. It is, therefore, proposed to draft a rule that places the risk of accidental deterioration and destruction on the **recipient of the performance**, i.e. in our standard example: the purchaser. It should not be objected that the reason why the contract has been terminated was non-conformity of the object delivered and received (with regard to other types of breach of contractual duty, such as default, an impossibility of performance, the problem of one party being unable to return the object received under the contract cannot normally arise). But, first of all, liability for non-conformity is not based on fault. And secondly: non-conformity and the impossibility to make restitution are intrinsically **unrelated** to each other. If one were to have a rule that would make the risk jump back to the seller in cases of termination, the non-conformity would be a lucky coincidence for the purchaser: he would be better off if the car received by him were defective than he would have been had the car not been defective. That would be distinctly implausible.

25. It should be noted that, unfortunately, the risk allocation proposed here does not tie in with the solution adopted by **CISG**. According to Art. 82 CISG, the purchaser looses the right to terminate the contract if it is impossible for him to make restitution of the goods substantially in the condition in which he received them (Art. 82 (1)). That does not, however, apply if the impossibility of making restitution is not due to his act or omission (Art. 82 (2)(b)). These rather involved provisions place the risk of accidental destruction at least very largely, and contrary to first appearances, on the seller, for if the purchaser retains the right to terminate, provided the impossibility to return is not due to his act or omission, he may claim back his purchase price even though he is unable to return the object received. But when is the impossibility to return due to the purchaser's "act or omission"? This is a very vague criterion rendering the risk rule's scope of application quite uncertain. What appears to be the general rule (Art. 82 (1)) turns out to be the exception after all (Art. 82 (2)(a)). And the general policy of saddling the seller with the risk is very questionable. These are three of the reasons why the risk regime of Art. 82 CISG is widely criticized in comparative legal literature and why it should not be regarded as a model on which the Unidroit regime can be based.

26. That brings us to the second, more technical question, i.e. how best to implement the risk regime. Essentially, two options are available to the draftsmen of a restitution regime. First, they can **exclude the right to termination** wherever the person who wants to terminate the contract is supposed to carry the risk of the impossibility of returning what he has given. For, since he is not allowed to terminate, he will not be able to reclaim whatever he has given (in our standard example, the purchase price). CISG uses this device which, in a way, perpetuates the model underlying the Roman *actio redhibitoria*. Alternatively, the law can still allow (in our standard example:) the purchaser to terminate the contract, and thus to reclaim the purchase price, but at the same time impose a liability on him **to make good the value** of the object received. 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.

27. It is widely agreed that, as between the two possible solutions, the imposition of a liability **to make good the value** is more subtle 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, on the other hand, can be flexibly adjusted depending on the extent to which there has been a deterioration.

28. The **basic rule** concerning restitution after termination might therefore look as follows: (1) On termination of the contract any performance received under it, as well as the benefits derived from such performance, have to be returned. (2) If restitution in kind is not

possible because of the nature of what has been received, compensation for value has to be paid. (3) Compensation for value also has to be paid insofar as the object received has deteriorated or has been destroyed. – In addition, of course, there has to be a rule stating that the obligations of the parties arising upon termination have to be performed concurrently.

29. It is obvious that there will have to be an **exception** to rule (3) to cover cases where the object deteriorates, or is destroyed, as a result of the defect inherent in it. Even though the defectiveness of the object supplied, and hence of the deterioration or destruction resulting from that defectiveness, may not be due to the seller's fault, it is still true to say that the risk of deterioration or destruction emanates from his sphere. A seller, in other words, who creates the risk which has to be distributed, cannot reasonably complain if he finds himself burdened with it. In order to cover this and related situations it may be appropriate to exclude the duty to pay compensation for value in all cases where the deterioration or destruction was **attributable to the other party** (i.e. the creditor).

30. Another situation for which one might want to exclude the duty to pay compensation is when the deterioration or destruction **would also have occurred** had the object still been with the seller. The following may serve as an example. A factory building has been sold and transferred to the purchaser; it is subsequently destroyed by a violent thunderstorm. The purchaser terminates the contract because of a defect attaching to the building. Or: A block of flats has been sold and transferred to the purchaser; it is subsequently disfigured by graffiti. Again, the purchaser terminates the contract because of a defect attaching to the garage. Here, an exception to the restitution-of-value rule would appear to be based on the consideration that the deterioration or destruction is not intrinsically related to the fact that the object, as a result of the executed contract of sale, has been in the purchaser's sphere of influence. Thus, there is no specific reason to burden the purchaser with the risk of deterioration or destruction by imposing an obligation on him to make good the value. On the other hand, however, it may be argued that at the moment when the object deteriorated or was destroyed, it *was* after all in the purchaser's sphere of control and influence; and it was he who was able to take out insurance for any accidental deterioration or destruction. These considerations might tip the balance **against the purchaser**, and thus against accepting such exception to the restitution-of-value rule. It is, therefore, proposed to amend rule (3) only along the following lines: Compensation for value also has to be paid insofar

as the object received has deteriorated or has been destroyed, unless and insofar as the deterioration or destruction is attributable to the other party.

31. The qualification "insofar as" in the latter part of that rule is due to the fact that the destruction may be attributable **to both parties** (the motor truck has been destroyed as a result of a collision with another car because it suffered from a defect *and* because the purchaser had been driving it too fast). In these situations, the risk has to be distributed equitably between the two parties concerned. This means that the purchaser cannot claim the full value. The situation, insofar, is similar to the one envisaged in Art. 7.4.7 (Harm due in part to aggrieved party), and should be treated in the same way.

32. Two further issues have to be considered. Take the following situation: A has sold and transferred a new car to B. B now uses the car for the next three months to commute to work and for a family holiday. The car then turns out to be defective and B terminates the contract. Of course, he can claim back the purchase price. In turn, he has to return the car and pay compensation for the benefits derived from driving the car. But does he also have to reimburse A for the fact that the car has deteriorated in value as a result of having been driven by B for three months? In view of the fact that B already has to make restitution for the benefits derived from the car, a positive answer may be seen to lead to an overcompensation on the part of A. It is, therefore, suggested to introduce a rule to the effect that a deterioration resulting from the **normal use** of the object is to be disregarded.

33. The second issue is this: if the purchaser is liable to make good the value of the object received if that object has deteriorated or is destroyed accidentally, or even due to *vis major*, he must also be liable if he cannot return the object because he has **consumed, transferred, encumbered, processed, or transformed** it. However, the exception recognized in cases of destruction or deterioration does not appear to be relevant here.

34. What happens if the object deteriorates, or is destroyed, *after* the contract has been terminated? 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 does not specifically need to be stated. Effectively, this means that, on termination, the risk of accidental deterioration or destruction shifts to the seller. Is that in contradiction

to the risk regime, envisaged above, for the time before termination? In a way, of course, it is. But then, upon termination, the situation changes. The purchaser now knows that he will have to return the object received. He is in exactly the same situation as anybody else who is under a duty to perform. Also, the shifting of the risk may induce him to terminate the contract as soon as he can which is in the interest of legal certainty.

35. The purchaser who has received the object of the sale may have incurred **expenses** for its maintenance and improvement. He should be compensated for these expenses. That applies in situations where he has to return the object, where he has to pay compensation for value, and where his duty to make good the value is excluded. In a way, this rule is the mirror image of the purchaser's duty to compensate the seller for the benefits derived from the use of the object. It may be advisable to let the purchaser also claim compensation for other expenses incurred on the object, but only to the extent that the other party is enriched by them.

36. In summary, then, the regime envisaged for **termination of contract** would consist of the following six rules:

(1) On termination of the contract any performance received under it, as well as the benefits derived from such performance, have to be returned.

(2) If restitution in kind is not possible because of the nature of what has been received, compensation for value has to be paid.

(3) Compensation for value also has to be paid (a) where the recipient has consumed, transferred, encumbered, processed, or transformed the object received and (b) insofar as the object received has deteriorated or has been destroyed, unless and insofar as the deterioration or destruction is attributable to the other party. Deterioration resulting from normal use is to be disregarded.

(4) Compensation for value has to be paid for the benefits that a party has failed to derive from the performance in accordance with ordinary business practice, provided the party knew or ought to have known of the ground for avoidance or termination.

(5) Compensation may be claimed for the necessary expenses incurred on the object received. Compensation for other expenses incurred on the object may be claimed as far as the other party is enriched by them.

(6) The obligations of the parties arising upon termination have to be performed concurrently.

37. We will now have to turn our attention again to **restitution after avoidance** of the contract. It has already been pointed out that rules (1), (2) and (6) are identical for termination and avoidance. The general risk rule (3)(b) revolves around the criteria of control and the ability to take out insurance. They apply to restitution after avoidance as much as to restitution after termination. The exception ("unless the deterioration or destruction was attributable to the other party") will probably be less relevant but certainly not irrelevant. It applies, for example, to the situation where A has fraudulently induced B to buy a motor-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.

38. It is often argued that in cases of avoidance another exception from the general risk rule has to be recognized in order **to protect minors**. Minors, so it is said, have to be protected against the detrimental consequences of legal transactions in which they may have engaged. They should, therefore, not be burdened with the risk of accidental destruction of an object that they have received. However, the Unidroit Principles, as they presently stand, do not deal with invalidity arising from lack of capacity (Art. 3.1 (a)). That means that they do not offer any protection against claims arising from a contract which they may have concluded. Under these circumstances, it cannot be the legitimate concern for a restitution regime to introduce minority protection in cases where a contract has failed (i.e., in a certain sense, through the back door).

39. The central question, therefore, is whether an exception has to be recognized in order to protect the position of a recipient who has been led to conclude the contract by the other party's **fraudulent representation**. What would be the result of the introduction of such an exception? (a) 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 A's garage. B can claim the vase back, while A

can neither claim the car nor its value. In other words, A has to carry the risk of destruction concerning the car. (b) 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 vase is accidentally destroyed while standing in A's home. B can claim the value of the vase from A; at the same time, he has to return the car to A. In other words, A also has to carry the risk concerning the vase. Thus, we have here a **cumulation of risks** in the person of A. Such cumulation of risks, however, does not appear to be required by the protective purpose of Art. 3.8. What is required is merely for the law to make sure that B is not bound by the contract he has entered into (unless, in spite of A's fraudulent behaviour, he wishes to be bound by it): that is why a right of rescission 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 either restitution in kind or restitution in value. But the rule on fraud does not intend to protect B against accidents. It is not the substitute for an insurance policy. A's fraudulent behaviour and the destruction of the car are quite unrelated to each other. The cumulation of risks in the person of A can only be justified as a penalty for A's fraud. Such idea, however, is alien to the law of contract. Moreover, the penalty would be quite arbitrary, if the matter is viewed from the perspective of the person to be penalized (A): he would be subject to a penalty if the car is destroyed while being in B's possession, but not if B is able to return it! It is therefore proposed not to introduce any further exception to the risk rule in cases of avoidance of the contract.

40. Rule (3)(a) also appears to be appropriate for restitution after avoidance, provided the reasoning in the previous paragraph is accepted as being sound. The same *argumentum a fortiori* would then appear to apply.

41. Rules (4) and (5) are also not intrinsically related to the problem of termination for non-performance. They should therefore also be included in a set of rules concerning avoidance.

42. If, then, the regime envisaged under 36 is also the one that should be applicable to cases of avoidance, that can be done by simply changing (1) so as to substitute the term "termination" by the term "avoidance". In addition, it appears to be possible to streamline the regime envisaged in rules (2) and (3) both for termination and avoidance. Since rules (2) and (3) cover, and are supposed to cover, all imaginable situations where restitution in kind is impossible, it is submitted that they can be combined by simply stating: (2) If

restitution in kind is not possible, compensation for value has to be paid. (3) In cases of destruction or deterioration the recipient of the performance does not have to pay compensation if, and insofar as, the destruction or deterioration is attributable to the other party. Deterioration resulting from normal use is to be disregarded.

43. Special problems can arise with regard to contracts to be performed **over a perio**d **of time**. Art. 7.3.6 (2) PICC has a special rule for that situation: as long as the contract is divisible, restitution can only be claimed for the period after termination has taken effect. The reason is that it can be inconvenient to unravel performances that have been made, in the past, over a long period of time. The example provided in the Official Comment is this: 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 the money paid for the three years of regular service. That solution certainly appears to be reasonable. Still, however, the rule will not always lead to satisfactory results. Imagine the following situation: 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. Under the normal rules on restitution after termination, as set out above (36), B would be able to claim what he has paid (rule (1), while only having to pay for the value of the services that A has rendered (rule (2)); and the **value** of the services that have in fact been rendered is **much less** than the payment agreed upon between A and B. If, as envisaged under Art. 7.3.6 (2), termination were to be effective only *pro futuro*, B would not be allowed to recover in a situation such as this. The PICC do not contain a right of price reduction; and B also does not appear to have sustained any harm as a result of A's partial non-performance (unless one were to say that he has suffered damages as a result of having paid for a performance that has only partly been rendered).

44. It is proposed, therefore, to take account of the legitimate concerns underlying Art. 7.3.6 (2) in the following way: "If performance of the contract has extended over a period of time, restitution can only be claimed for the period after termination has taken effect, if neither of the parties has a **reasonable interest** in the mutual restoration of the

past performances and if the contract is divisible". The reason for undoing the past performances must not just be the desire to escape from what appears in hind-sight to be a bad bargain. That is brought out by the word "reasonable".

45. The PICC do not deal with this problem in the context of **avoidance** where, 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 then 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. It would be in accordance with what is done at least in some legal systems, e.g. German law. Once again, of course, this cannot apply if the contract is indivisible and if one of the parties (i.e. usually the party avoiding the contract) has a **reasonable interest** in the mutual restoration of the past performances. The latter situation will occur much more often with regard to avoidance than with regard to termination, for contracts entered into under the influence of fraud or threat will often involve an element of disparity between performance and counter-performance. The same, *ex definitione*, holds true in cases falling under Art. 3.10 (Gross disparity). The protective purpose of Arts. 3.8, 3.9 and 3.10 would thus, normally, require a restoration also of the performances (or their value) for the past.

46. As a result, therefore, the model regulation sketched above sub 36 and 42 will have to be amended by a rule dealing with contracts to be performed over a period of time, as set out under 44. Systematically, it should be placed before the present rule (6), in view of the fact that the concurrency rule would also apply if restitution has to be made concerning a long-term contract.

47. It would appear to be awkward to overload Chapter 7, Section 3 on termination with 7 new rules, and it might therefore be preferable either to introduce a new Section 3a entitled "Restitution (after termination)", or to subdivide Section 3 into Subsection 3a: "Termination in General" and Subsection 3b "Restitution (after termination)". Matters are more difficult when it comes to restitution following upon avoidance. The introduction of a set of 7 rules on restitution would not fit the structure of the Chapter. But the introduction of an individual Section on restitution would be equally awkward. In addition, the PICC which generally have the advantage of being short and of avoiding repetition, would now

be burdened with two identical sets of rules. Thus, I think, there is a good argument for introducing a **separate Chapter** (7a) dealing with the **unwinding of failed contracts**. It could either be entitled "Restitution" or "Restitution after failure of contract". And it would contain the following set of rules:

(1) If a contract has been avoided, or terminated, any performance received under it, as well as the benefits derived from such performance, have to be returned.

(2) If restitution in kind is not possible, compensation for value has to be paid.

(3) In cases of destruction or deterioration the recipient of the performance does not have to pay compensation if, and insofar as, the destruction or deterioration is attributable to the other party. Deterioration resulting from normal use is to be disregarded.

(4) Compensation for value also has to be paid for the benefits that a party has failed to derive from the performance in accordance with ordinary business practice, provided the party knew or ought to have known of the ground for avoidance or termination.

(5) Compensation may be claimed for the necessary expenses incurred on the object received. Compensation for other expenses incurred on the object may be claimed as far as the other party is enriched by them.

(6) If performance of the contract has extended over a period of time, restitution can only be claimed for the period after termination has taken effect, if neither of the parties has a reasonable interest in the mutual restoration of the past performances and if the contract is divisible.

(7) The obligations of the parties arising upon termination have to be performed concurrently.

48. The model rules proposed here are, obviously, just a first draft. The purpose of this paper was to highlight the main problems, as I see them, and to suggest how they might be resolved. The paper has been written inductively and with an open mind towards the issues raised, but not yet decided, by the meeting of the Working Group last year. It has not been

burdened by references to comparative material. The main comparative works that have been used are:

G.H. Treitel, Remedies for Breach of Contract, 1988; Rainer Hornung, Die Rückabwicklung gescheiterter Verträge nach französischem, deutschem und nach Einheitsrecht, 1998; Peter Schlechtriem, Restitution und Bereicherungsausgleich in Europa, 2000; Christoph Coen, Vertragsscheitern und Rückabwicklung, 2003; Phillip Hellwege, Die Rückabwicklung gegenseitiger Verträge als einheitliches Problem: Deutsches, englisches und schottisches Recht in historisch-vergleichender Perspektive, 2004; cf. also Reinhard Zimmermann, Restitution in integrum, (2005) 10 Uniform Law Review 719 ff.