POLICING THE INTERNATIONAL COMMERCIAL CONTRACT AGAINST UNFAIRNESS UNDER THE UNIDROIT PRINCIPLES

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I. INTRODUCTION

Courts, when regulating parties' bargaining process by policing agreements designed to prevent contractual unfairness, must consider two competing policy interests.[1] One is the interest in the stability or security of transactions and the protection of parties' expectations. The other is the interest in preventing contractual unfairness and protecting against overreaching by one or more parties.[2] Although the latter interest has recently received more attention, as illustrated by its incorporation into the UNIDROIT Principles of International Commercial Contracts

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1. E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.1 (1990).
2. *Id.*

(Principles),[3] the former has thus far prevailed in international trade law practice.[4] This prevalence is evidenced by the fact that none of the existing legislative instruments, including comprehensive uniform commercial codes, address questions of the substantive validity of the contract.[5] The reasons for the failure to address questions concerning substantive contractual validity arise from (1) the difficulty in overcoming the differences between legal systems regarding issues of substantive contractual validity[6] and (2) the unfounded assumption that international trade contracts do not suffer from substantive validity problems because merchants, unlike consumers, are sophisticated players in the contracting process.[7]

The Principles,[8] however, are drafted in order to avoid substantive unfairness in contracts.[9] The Principles, by addressing concerns beyond traditional invalidity concepts[10]—such as mistake,

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3. INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW, PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (1994) [hereinafter UNIDROIT PRINCIPLES].

4. *See* Helen Elizabeth Hartnell, *Rousing the Sleeping Dog: The Validity Exception to the Convention on Contracts for the International Sale of Goods*, 18 YALE J. INT'L L. 1, 4, 26 (1993).

5. *See, e.g.*, U.N. CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS, U.N. Doc. A/CONF.97/19, U.N. Sales No. E.81.IV.3 (1981) [hereinafter Vienna Sales Convention].

6. *See, e.g.*, A. Tunc, *Commentary on the Hague Conventions of the 1st of July 1964 on International Sale of Goods and the Formation of the Contract of Sale*, *in* DIPLOMATIC CONFERENCE ON THE UNIFICATION OF LAW GOVERNING THE INTERNATIONAL SALE OF GOODS, RECORDS AND DOCUMENTS OF THE CONFERENCE (The Hague 2-25 April 1964).

7. *See, e.g.*, *Report of the Secretary-General: Formation and Validity of Contracts for International Sale of Goods*, *reprinted in* 8 UNITED NATIONS, UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE [hereinafter UNCITRAL] 93 (1977) (supporting recommendation to exclude from the new Convention on Contracts for the International Sale of Goods any provisions contained in the draft uniform law on validity prepared by UNIDROIT in 1972). *Cf.* UNIDROIT, REPORT ON MAX-PLANCK INSTITUT FÜR AUSLANDISCHES UND INTERNATIONALES PRIVATRECHT, Etude XVI/B, Doc. 22 (published in conjunction with draft uniform law on validity prepared by UNIDROIT), *reprinted in* 1 UNIFORM L. REV. 61 (1973) (basing its conclusions exclusively upon the findings of two Western European arbitration institutions).

8. UNIDROIT PRINCIPLES, *supra* note 3; *see also* M.J. Bonell, *Unification of Law by Non-Legislative Means: The UNIDROIT Draft Principles for International Commercial Contracts*, 40 AM. J. COMP. L. 617 (1992).

9. *See* UNIDROIT, REPORT ON SECRETARIAT OF UNIDROIT ON THE 1ST MEETING OF THE WORKING COMMITTEE ON THE PROGRESSIVE CODIFICATION OF INTERNATIONAL TRADE LAW 9, Study L-Doc. (1974); UNIDROIT, REPORT ON MEETING OF XX HELD IN COPENHAGEN ON MARCH 31 AND APRIL 1, 1980, at 3, P.C.-Misc. (1980).

10. *Law for Unification for Uniformity of Certain Rules relating to Validity of Contracts of International Sale of Goods* approved by the UNIDROIT Governing Council on May 5, 1972, *cited in Report of the Secretary-General: Formation and Validity of Contracts for the International Sale of Goods*, *reprinted* in 8 UNCITRAL, *supra* note 7, at 91.

fraud, and threat—represent a change in attitude which is attributable to both the nature of the Principles themselves and the recent trends in international trade. First, the Principles are not intended to become a binding instrument and are therefore much less likely to be conditioned by the differences between domestic laws.[11] Second, the Principles are sufficiently flexible to encompass new international trade developments, including shifting cross-border relationships made either exclusively between nations with similar political and economic conditions, or between nations with significantly different backgrounds.[12]

This Article examines three sets of Principles which police contract formation in order to prevent unfairness: first, the provisions which qualify the use of standard contract terms and prevent contractual abuse, such as fraud and threat; second, the criteria established to eliminate or adapt unfair contract terms; and third, the treatment of *gross disparity* involving both procedural and substantive unfairness.

II. POLICING BARGAINING BEHAVIOR

A. Fraud and Threat

Under Article 3.8, a party may avoid a contract induced by the other party's "fraudulent representations . . . or fraudulent non-disclosure" of relevant facts.[13] A party behaves fraudulently if the misrepresentation or nondisclosure was "intend[ed] to lead the other party into error and thereby gain an advantage to the detriment of the other party."[14] Such fraudulent representations may be either express statements or mere conduct.[15]

Like the majority of domestic laws, the Principles do not impose a general duty to disclose.[16] Thus, a party can only avoid a contract

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11. *See* UNIDROIT PRINCIPLES, *supra* note 3, at ix.
12. *See id.*
13. *Id.* art. 3.8.
14. *Id.*
15. *Id.* art. 3.8 cmt. 1. Examples of conduct constituting a fraudulent representation might include decorating a store to resemble a specific franchise chain or covering up a defective wall of a building for sale.
16. *See, e.g.*, FARNSWORTH, *supra* note 1, § 4.11, at 406-07 (with respect to U.S. law); CHESHIRE, FIFOOT & FURMSTON, CHESHIRE, FIFOOT AND FURMSTON'S LAW OF CONTRACT 273, 302-08 (12th ed. 1991) (with respect to English law); KRAMER § 123 no. 14, *cited in* Münchener Kommentar (C.H. Beck'sche Verslagsbuchhandlung 1993) (with respect to German law);

where there is fraudulent misrepresentation "or fraudulent non-disclosure of circumstances which, according to reasonable commercial standards of fair dealing, should have [been] disclosed."[17] Although the Principles do not provide a hard and fast rule establishing a duty to disclose, they consider several factors relevant to a determination of whether such a duty exists: (1) the special expertise of the party with an alleged duty to disclose; (2) the ease with which the other party could have obtained outside information; (3) the nature of the contract; and (4) the type of relationship between the contracting parties.[18]

According to Article 3.9, threat may be grounds for avoidance where it is both (1) unjustified and (2) so imminent and serious as to leave the victim no reasonable alternative.[19] The former, more controversial requirement is difficult to prove while the latter is usually not problematic. In order to prove the latter requirement, a threatened party must demonstrate that a veritable threat existed based on an objective standard as determined by the surrounding circumstances.[20]

As for the former requirement, an act or omission which is itself lawful usually constitutes an unjustified threat if it is used to induce another party to accept the contract.[21] Unfortunately, because the Principles fail to address and resolve all possible scenarios, inconsistent results are inevitable. For instance, a threat to terminate or not perform a contract might be unjustified in some circumstances but may be a legitimate exercise of a party's power in other situations.[22] Similarly, while a threat to use evidence to pursue a criminal charge against the other party usually is illegal, a threat to commence civil proceedings may well be legitimate, especially where the accused party can easily defend

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JACQUES GHESTIN, TRAITÉ DE DROIT CIVIL: LES OBLIGATION LE CONTRACT [TREATISE OF CIVIL LAW: OBLIGATIONS, THE CONTRACT] (1980) (with respect to French law); C.M. BIANCA, DIRITTO CIVILE: IL CONTRACTO [CIVIL LAW: THE CONTRACT] (with respect to Italian law).

17. UNIDROIT PRINCIPLES, *supra* note 3, art. 3.8.

18. *See id.* art. 2.16. An example of type of relationship in which there would be a duty to disclose is the physician-patient relationship.

19. *Id.* art. 3.9.

20. *Id.* art. 3.9 cmt. 1. For example, the announcement of negative consequences if the victim does not accept to conclude, modify or terminate a particular contract, may not constitute a veritable threat where those consequences are likely to occur even in the absence of affirmative action by the threatening party. Illustratively, a party's threat to revoke a license may not be considered a veritable threat, if due to objective reasons the respective authorities would have revoked the license.

21. *Id.* art. 3.9 cmt. 2.

22. *See* RESTATEMENT (SECOND) OF CONTRACTS § 176(c) (1981) (as to modification).

itself in court.[23] Ultimately, each case must be evaluated individually to determine whether the threatening party acted according to the Principles' general good faith requirements.[24]

Finally, under Article 3.11, a party can be held responsible for a third party's fraud or threats made to induce a contract where that party is responsible for the third party's actions.[25] Otherwise, the victim can only avoid the contract if that party knew or should have know about the third party's fraud or threats.[26]

B. Possible Abuses in Contracting on the Basis of Standard Terms

As in the domestic sphere, certain international trade sectors have traditionally recognized standardized contract terms.[27] To prevent contractual unfairness, however, the Principles safeguard a party from another party's potential abuse of such terms. According to Article 2.19, general rules of construction are to be applied regardless of whether one or both parties use standard terms.[28] To incorporate standard contract terms, the parties must either expressly or implicitly refer to these terms in the contract.[29] If standard terms are impliedly referred to, they will be admitted only where incorporation of the terms corresponds to a course of dealing that has been established between the

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23. *Id.*

24. *See* UNIDROIT PRINCIPLES, *supra* note 3, art. 1.7. In substance, this is the underlying idea of article 1438 of the Italian Civil Code, according to which "[a] threat to enforce a right can be cause for annulment of a contract only when it is aimed at obtaining unjust benefits." CODICE CIVILE [C.C.] art. 1483 (Italy). *But see, e.g.*, CODE CIVIL DU QUEBEC, art. 1403 ("La crainte inspirée par l'exercise abusif d'un droit ou d'une autorité ou par la menace d'un tel exercise vicie le consentement.") [("[A]ny duress produced by an abusive exercise of right or authority or by a threat thereof vitiates consent.")].

25. UNIDROIT PRINCIPLES, *supra* note 3, art. 3.11. *See, e.g.*, BURGERLIJK WETBOEK [BW] book 3, art. 44(5) (Neth.); *see also* BÜRGERLICHES GESETZBUCH [BGB] art. 123(2) (Ger.) (with respect to fraud only); C.C. art. 1439(2). *But see* RESTATEMENT (SECOND) OF CONTRACTS, § 164(2) (stating that a party's knowledge or negligent ignorance of another party's fraud is irrelevant and thus denying avoidance only where that party "without reason to know of the misrepresentation either gives value or relies materially on the transaction").

26. UNIDROIT PRINCIPLES, *supra* note 3, art. 3.11.

27. Standardized contracts at the international level have several advantages: (1) the reduction of transaction costs, (2) greater predictability and certainty of contract terms, and (3) the elimination or lessening of language barriers. On the other hand, parties can unwittingly or unwillingly abuse standard contract terms to disadvantage the other party. This is especially true at the international level, where business people's sophistication and negotiation skills vary greatly among countries.

28. UNIDROIT PRINCIPLES, *supra* note 3, art. 2.18 cmt. 3.

29. *See id.* art. 1.8.

parties or to a usage of trade which is widely known and regularly observed in the particular trade concerned.[30]

Where the general rules governing the incorporation of standardized terms are applied, such terms may be in effect substantively imposed on the adhering party.[31] Since standard contract terms are sometimes lengthy, printed in small characters and therefore purposely inconspicuous, or drafted in complex language, adhering parties may accept these terms without reading or fully understanding their legal implications. Nonetheless, under general rules of contract law, the adhering party would still be bound by such terms.[32] The Principles, however, provide three significant exceptions to these general contract rules and thereby offer protection of the adhering party against the risk of unfair imposition by the use of standard terms.[33]

First, Article 2.20 prohibits a party from incorporating "surprising terms"—or, standard contract terms which, by virtue of their content, language, or presentation, are of such a character that the other party would not have reasonably expected their inclusion in the contract.[34] Article 2.20 renders "surprising terms" ineffective unless the other party explicitly agrees to them.[35] According the Comment, the exception provided under this Article reflects the drafters' desire to ensure that "a party which uses standard terms . . . [does not take] undue advantage of its position by surreptitiously attempting to impose terms on the other party which that party would scarcely have accepted had it been aware of them."[36]

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30. *Id.* These requirements represent a compromise between such provisions as the 1976 German Law on Conditions, requiring standard terms to be explicitly incorporated and the Italian Civil Code, binding a performing party if it knew or should have knew standard terms were included in the contract. GESETZ ZUR REGELUNG DES RECHTS DER ALLGEMEINEN GESCHÄFTSBEDINGUNGEN [AGBG] § 2 (Joachim Gres et al. trans., 1977). This section also requires that the adhering party receive an opportunity to familiarize itself with the conduct of the standard terms. *Id.* However, the special requirements provided for in § 2 do not apply to contracts between merchants. *Id.* § 24. *Compare* C.C. art. 1341(1). *See also* BW, book 6, art. 232 (stating that an adhering party is bound by standard terms even if, at the time of entering the contract, the other party knew that adhering party did not know the content of those terms).

31. *See* UNIDROIT PRINCIPLES, *supra* note 3, art. 2.19.

32. *Id.* art. 2.20 cmt. 1.

33. *See id.* arts. 2.20, 2.21, 4.6.

34. *Id.* art. 2.20(2).

35. *Id.* art. 2.20(1).

36. UNIDROIT PRINCIPLES, *supra* note 3, art. 2.20 cmt. 1.

Second, Article 2.21 states that where a conflict arises between standard and nonstandard terms, the nonstandard terms prevail.[37] The underlying rationale behind this exception is a policy of enforcing contracts so as to conform to the expectations of the parties.[38] Since parties specifically negotiate nonstandard terms, such terms should prevail over conflicting standard terms because they more likely reflect the parties' intentions.[39]

Finally, Article 4.6 provides for the a *contra proferentum* rule.[40] This rule requires that an ambiguous contract provision be construed against the party who supplies the language.[41] *Contra proferentum*, because it applies to all "contract terms supplied by one party," will play an important role in regulating standard terms which, by their very nature are "supplied" by one of the parties and are not subject to further negotiation between parties.[42]

Generally, the above exceptions do not reflect a significant departure from existing national laws which regulate the use of standard terms.[43] Typically, the *contra proferentum* rule and the rule granting negotiated terms preference over standard terms are either expressly codified within a nation's domestic laws[44] or generally recognized[45] by national courts. On the other hand, with respect to surprising terms, this preference is achieved by the application of national laws which generally impose formal requirements for their acceptance. As such, national

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37. *Id.* art. 2.21 cmt. Article 2.21 defines standard terms as "provisions . . . prepared in advance for general and repeated use by one party and which are actually used without negotiation with the other party." *Id.* In practice, without striking out the conflicting provisions contained in the standard terms, difficulties may arise in distinguishing between those terms which have been negotiated and those which have not, as well as oral modifications to standard terms, where the standard terms contain a provision stating the exclusive character of the writing signed by the parties, or that any addition to or modification of their content must be in writing. *Id.* art. 2.21 cmt.

38. *See id.* art. 2.21 cmt.

39. *Id.*

40. *Id.* art. 4.6.

41. *Id.*

42. UNIDROIT PRINCIPLES, *supra* note 3, art. 4.6; *see* CODE CIVIL [C. CIV.] art. 1162 (Fr.).

43. *See, e.g.*, UNIDROIT PRINCIPLES, *supra* note 3, art. 4.6.

44. *See* C.C. art. 1370; CODE CIVIL DU QUEBEC art. 143; LA CIV. CODE ANN. art. 2056 (West 1994); AGBG §§ 4, 5.

45. *Cf.* G.H. TREITEL, THE LAW OF CONTRACTS 171-72 (7th ed. 1987) (with respect to English law); FARNSWORTH, *supra* note 1, § 4.26 (with respect to U.S. law).

courts in effect achieve the same results as would be reached under the Principles.[46]

III. POLICING THE SUBSTANCE OF THE AGREEMENT

With respect to the above-mentioned techniques, Karl Llewellyn has correctly pointed out that they "all rest on the admission that the clauses in question are permissible in purpose and content, [and] . . . they invite the draftsman to recur to the attack . . . . [G]ive him time, and he will make the grade. . . . Covert tools are never reliable tools."[47] Or, in the words of Allan Farnsworth, "None of the traditional judicial techniques is adequate . . . to protect an unfortunate person who has actual knowledge, i.e. who reads the terms that the other party means to include and who understands how the other party would have them interpreted."[48]

The Principles generally do not permit the adhering party to strike out unfair contract terms or terms included in a standard clause merely because they are unfair.[49] However, certain exceptions to this general prohibition—namely, the provisions on usages of trade, exemption clauses, agreed payment for nonperformance, and gross disparity—do exist under the Principles.

A. Usages of Trade

Article 1.8(2) expressly states that usages of trade do not bind parties whenever their application would be unreasonable.[50] Although a particular usage of industry may, under normal circumstances, generally

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46. For example, the Italian Civil Code contains a list of particularly "onerous" terms that, if included in a contract, must be approved in writing by the other party. C.C. art. 341(2). Similarly, in numerous cases, the U.S. Uniform Commercial Code (U.C.C.) requires that a terms be "separately signed" to protect against inadvertent incorporation. UNIFORM COMMERCIAL CODE [U.C.C.] §§ 2-205, 2-209(2) (1993). The U.C.C. also requires that a disclaimer of an implied warranty of merchantability specifically mention "merchantability" and that, if written, the disclaimer must be "conspicuous," so that "a reasonable person against whom it is to operate ought to have noticed it." *Id.* §§ 2-316(2), 1-201(10). Also, the Dutch Civil Code provides that an adhering party can avoid specific terms where it did not have a reasonable opportunity to familiarize itself with the individual terms in the standard clauses. BW book 6, art. 233(b).

47. K.N. Llewellyn, Book Review, 52 HARV. L. REV. 700, 703 (1939) (reviewing O. PRAUSNITZ, THE STANDARDIZATION OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW (1937)).

48. FARNSWORTH, *supra* note 1, § 4.26.

49. *See* UNIDROIT PRINCIPLES, *supra* note 3, art. 3.10.

50. *Id.* art. 1.8(2).

be reasonable, it may nevertheless be unreasonable because of (1) special conditions under which one or both of the parties is operating or (2) the atypical nature of the transaction at issue.[51] It remains unclear, however, whether this "unreasonableness" test denies application of a trade usage standard where it would result in unfair surprise to only one party.[52]

B. Exemption Clauses

Applying the doctrine of freedom to contract, the Principles, like most national laws, assume that parties are free to both (1) limit or exclude liability and (2) to provide a means by which to "escape" in the event of nonperformance.[53] At the same time, because international trade contracts, like consumer contracts, frequently contain exemption or exculpatory clauses which are often grossly unfair, the Principles' drafters felt it was necessary to protect parties from such clauses and therefore provided an exception under Article 7.1.6.[54] This Article provides that "[a] term which limits or excludes one party's liability for nonperformance or which permits one party to render performance substantially different from what the other party reasonably expected"[55] may not be invoked if it would be grossly unfair to do so.

At first glance, civil and common law approaches vis-à-vis exemption clauses appear to differ considerably. Theoretically, civil law systems draw a clear distinction between exemption clauses for intentional breach and those for any other cause of nonperformance, finding the former a priori invalid.[56] In contrast, common law systems, refusing to draw such a distinction, do not formally consider a party's state of mind with regard to exemption clauses. Rather, taking all of the

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51. *Id.* art. 1.8 cmt. 5.

52. *See* U.C.C. § 1-205(6) ("Evidence of a relevant usage of trade offered by one party is not admissible unless and until he has given the other party such notice as the court finds sufficient to prevent unfair surprise to the latter."). Specifically, "[S]ubsection (6) is intended to ensure that this Act's liberal recognition of the needs of commerce in regard to usage of trade shall not be made into an instrument of abuse." *Id.* § 1-205 cmt. 2.

53. *See* UNIDROIT PRINCIPLES, *supra* note 3, art. 1.1.

54. *Id.*

55. *Id.* art. 7.1.6.

56. *See, e.g.*, BGB art. 276(2); *see also* CODE DES OBLIGATIONS [CO] art. 100 (Switz.) (noting the invalidity of exemption clauses for gross negligence); C.C. art. 1229(1) ("Any agreement in advance purporting to exclude liability for intentional illegality or gross negligence is void."); Judgment for June 29, 1932, Cass. civ., 1933 Recueil Dalloz [D.P.] 49 note Josserand (Fr.); Judgment of May 7, 1980, Cass. civ., 1981 Recueil Sirey [S. Jur.] 245 note F. Chabas (Fr.) (noting that exemption clauses also invalid for gross negligence).

circumstances into account, common law systems focus on more general and flexible criteria, such as "reasonableness" or "unconscionability."[57]

The Principles initially resembled the civil law treatment of exemption clauses.[58] However, certain members of the Working Group criticized the provision, finding that: (1) the concepts of intentional and grossly negligent nonperformance are inherently unclear, (2) a party's decision not to perform is not blameworthy in and of itself, and (3) the problem with exception clauses stems not so much from their construction as from the unreasonable or unconscionable consequences they may produce.[59] These criticisms within the Working Group led to amendment of the provision so as to cover clauses that allow performing parties to unilaterally alter the nature of the performance promised.[60] At the same time, the decisive criterion to determine the validity of such clauses became whether, in context of the contract's objectives, reliance on the clause would be grossly unfair.[61] This does not mean, however, that the state of mind of the nonperforming party will not continue to play an important role. As pointed out in the Comment to Article 7.1.6, the fact that such party acted intentionally or with gross negligence may be sufficient in order to conclude that its reliance on the exemption clause would be grossly unfair.[62]

C. Agreed Payment for Nonperformance

Article 7.4.13 allows direct intervention on the sole ground of the unfairness of a contract term per se.[63] Under Article 7.4.13, contract terms which provide payment of a specific amount of money for nonperformance are generally valid, regardless of whether the stated

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57. It is important to note that the civil law approach accounts for the dichotomy between contractual obligation and the right to deliberately disregard this obligation. In contrast, the common law focuses on the substance rather than the construction of exemption clauses. Despite their differences, civil and common law systems frequently lead to similar conclusions. When evaluating the validity of an exemption clause, civil law sometimes considers factors other than the breaching party's intent. Likewise, common law statutes often render exemption clauses ineffective to excuse negligent parties from liability.

58. UNIDROIT, SUMMARY RECORDS OF MEETING HELD IN ROME FROM 27 TO 31 MAY 1991, P.C.-Misc. 17 (1993).

59. *Id.*

60. *Id.*; *see* UNIDROIT PRINCIPLES, *supra* note 3, art. 3.14.

61. UNIDROIT, SUMMARY RECORDS OF MEETING HELD IN ROME FROM 27 TO 31 MAY 1991, at 114, P.C.-Misc. 17 (1993).

62. *Cf.* UNIDROIT PRINCIPLES, *supra* note 3, art. 7.1.6 cmt. 5.

63. *Id.* art. 7.4.13

amount corresponds to the anticipated or actual harm.[64] The stated amount may nevertheless be reduced, but only in instances where it is grossly excessive in relation to the actual harm caused by non-performance or other circumstances.[65] In civil law, these clauses, often called penalty clauses, are generally recognized.[66] In contrast, the common law has traditionally distinguished between penalty clauses and liquidated damages clauses. Under common law, penalty clauses, because they deter breaches of contract by creating an *in terrorem* effect, are per se invalid.[67] On the other hand, liquidated damages clauses, because they genuinely estimate the economic costs arising from a contract breach, are valid.[68]

Article 7.4.13 presents an innovative approach that arguably may better address the problem than the common law approach. In the United States, the historical distinction between penalty and liquidated damages clauses has come under question, especially where the parties to a contract possess equal bargaining power.[69] This re-evaluation has led to a more tolerant attitude toward penalty clauses as long as they do not completely disregard the principle of compensation.[70] If this current trend continues, it is likely that common law nations will move closer to and eventually adopt the provisions recommended by the Principles.

Common law systems could easily incorporate Article 7.4.13 because its provisions do not differ substantially from the traditional "all-or-nothing" approach.[71] For example, although a court in a common law

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64. *Id.* art. 7.4.13(1).

65. *Id.* art. 7.4.14(2).

66. *See, e.g.*, BGB art. 343; C.C. art. 1384; BW book 6, art. 94; C. CIV. arts. 1152(2), 1231 (as amended in 1975); *see also* LA. CIV. CODE ANN. art. 2005 (West 1994). While the Louisiana Civil Code follows in substance the civil doctrine *clause penale*, it no longer uses the expression "penal clause." *Id.* Rather, the Louisiana Civil Code, "attempt[ing] to make a fresh start in this area[,]" adopted a more neutral expression of "stipulated damages," which "[a]lthough . . . similar to the common law 'liquidated damages,' . . . is not of such common usage in either the civil or common law tradition as to impart any definite doctrinal meaning of its own." *Id.* art. 2005 cmt. b.

67. *See* G.H. TREITEL, REMEDIES FOR BREACH OF CONTRACT: A COMPARATIVE ACCOUNT 229 (1988).

68. *See id.*

69. *See* FARNSWORTH, *supra* note 1, § 12.18. Section 2-718(1) of the U.C.C. requires that the stipulated sum be "reasonable in light of the anticipated or *actual* harm caused by the breach," thereby expanding the ambit of the enforcement of liquidated damages clauses. U.C.C. § 2-718(1) (emphasis added); *accord* RESTATEMENT (SECOND) OF CONTRACTS § 356.

70. FARNSWORTH, *supra* note 1, § 12.18.

71. *See* UNIDROIT PRINCIPLES, *supra* note 3, art. 7.4.13 cmt. 2.

jurisdiction will traditionally strike out a penalty clause, it may nevertheless award damages to compensate for actual harm.[72] Similarly, under the modern doctrine of unconscionability, a common law court may set aside manifestly unreasonable contract terms, including a disproportionate penalty clause.[73] Thus, common law courts, refusing to recognize the per se validity of liquidated damages clauses, instead prefer to admit penalty clauses as in principle valid, and then subject them to the unconscionability test.[74] By reducing an unequitable but agreed upon amount, Article 7.4.13 follows the doctrine of unconscionability insofar as it allows a court to limit the application of a contract term, rather than eliminate the contract term altogether.[75] It is important to note that this Article only reduces the agreed amount and does not completely disregard the penalty clause.[76] However, if it would be grossly unfair for a party in breach to rely on a penalty clause which fixes a clearly inadequate sum to compensate for the expected harm, Article 7.1.6 may render such a clause ineffective as a limitation on liability.[77] Moreover, if the clause violates the gross disparity provisions under Article 3.10, a court may ignore the amount agreed upon in its entirety and award damages equal to the actual harm caused by the nonperformance.[78]

In short, as with unreasonable usages of trade, intervention is likewise warranted for both exemption and agreed payment for nonperformance clauses. However, unlike with usages of trade, both exemption and nonperformance penalty clauses trigger a more direct intervention merely because of their substantive unfairness.

IV. POLICING THE COMBINATION OF PROCEDURAL AND SUBSTANTIVE UNFAIRNESS: GROSS DISPARITY

In Article 3.10, the Principles address gross disparity among parties. Under the gross disparity provision, an adhering party may set aside a contract or any of its individual terms which give the other party

72. FARNSWORTH, *supra* note 1, § 12.18.

73. *See id. Compare id*. § 4.28 (stating that a court may refuse to set aside an unconscionable clause).

74. *See* FARNSWORTH, *supra* note 1, § 12.18.

75. *See* U.C.C. § 2-302; RESTATEMENT (SECOND) OF CONTRACTS § 208.

76. *See* UNIDROIT PRINCIPLES, *supra* note 3, art. 7.4.13 cmt. 3.

77. *See id.* art. 7.1.6 cmt.

78. *Id.* art. 3.10.

an unjustifiably excessive advantage.[79] Unlike the exemption and nonperformance clauses, Article 3.10 requires that excessive advantage arise from both substantive unfairness alongside a superior bargaining position.[80]

A. Origin of Article 3.10

Article 3.10 was particularly difficult to draft. Professors Ulrich Drobnig and Ole Lando co-authored the original draft of the chapter concerning the substantive validity of contracts, which contained what proved to be two extremely controversial articles.[81] The first article entitled "Unequal Bargaining Power" stated that

> [a] party may avoid a contract when the other party has taken advantage of his dependence, economic distress or urgent needs, or if his improvidence, ignorance, inexperience or lack of bargaining skill, to obtain terms which make the contract as a whole unreasonably advantageous for the other party and unreasonably disadvantageous for him.[82]

The other article, entitled "Gross Unfairness," provided that "[a] party may avoid or have revised a contract if at the time of the making of the contract there is an unconscionable disparity between the obligations of the parties or other unconscionable contract terms which grossly upset the contractual equilibrium."[83]

When the draft articles were received by the Working Group[84] and an ad hoc Study Group,[85] members of both groups disagreed over the content of the gross disparity provision. Those in favor of the gross

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79. *Id.*

80. *Id.*

81. UNIDROIT, PROPOSED RULES ON THE (SUBSTANTIVE) VALIDITY OF INTERNATIONAL CONTRACT (EXCLUDING ILLEGALITY) and Explanatory Note, arts. 7, 8 (prepared by Prof. U. Drobnig, Co-Director of the Max-Planck-Institut für Ausländisches und Internationales Privatrecht and Prof. O. Lando, Director of Institute of European Market Law, Copenhagen School of Economics and Business Administration), Study L-Doc. 17 (1980).

82. *Id.* art. 7.

83. *Id.* art. 8.

84. *See* UNIDROIT, REPORT ON MEETING HELD IN LOUVAIN-NEUVE FROM 11 TO 13 APRIL 1983, at 7, , P.C.-Misc. 4 (1983); UNIDROIT, SUMMARY RECORDS OF MEETING IN ROME HELD 16 TO 20 JANUARY 1989, at 26-41, P.C.-Misc. (1989).

85. *See* UNIDROIT, REPORT OF THE STUDY GROUP HELD IN ROME 5 TO 9 APRIL 1982, at 6-9, 2d Sess., Study L-Doc. 22 (1982).

disparity provision asserted that Article 39—covering cases where one party, in order to gain an "excessively favorable" bargain, takes unfair advantage of another party—failed to encompass all instances involving grossly unfair contracts.[86] These members stressed that most domestic laws include additional or alternative provisions that set aside terms which are grossly unfair per se.[87] Members who opposed the gross disparity provision contended that it is a contract's content, not the behavior of the contracting parties, which is decisive. As such, they argued that the property sanction was to nullify the contract rather than, upon the victimized party's request, to avoid it.[88] These opposing members also objected on the grounds that the provision as drafted was misplaced because it failed to address the chapter's chief concern—the vitiation of consent.[89] Finally, opponents to the provision argued that in the context of international trade contracts, the gross disparity provision

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86. *See id*; REPORT ON MEETING HELD IN LOUVAIN-NEUVE FROM 11 TO 13 APRIL 1983, *supra* note 84; SUMMARY RECORDS OF MEETING IN ROME HELD 16 TO 20 JANUARY 1989, *supra* note 84.

87. *See, e.g.*, BGB art. 138

> (1) A legal transaction which is against public policy is void. (2) A legal transaction by which a person exploiting the need, inexperience, lack of sound judgment or substantial lack of will power of another causes to be promised or granted to himself or a third party in exchange for a performance, pecuniary advantages which are in obvious disproportion to the performance is also void.

AGBG § 9 (with respect to standard terms); SCANDINAVIAN CONTRACT LAW arts. 31, 36 (as amended in 1975 and 1982) (Scand.); CODE CIVIL DU QUÉBEC arts. 1405, 1437.

The most important examples of the second type of provisions, relating to unconscionable contracts or contract terms, are found in the U.C.C. and Restatement (Second) of Contracts. *See* U.C.C. § 2-302(1) ("If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without any unconscionable clause, or it may limit the application of any unconscionable clause to avoid any unconscionable result."); RESTATEMENT (SECOND) OF CONTRACTS § 208. *See also* Council Directive 93/13 on Unfair Terms in Consumer Contracts, art. 3(1) 1993 O.J. (L 95) (with respect to standard terms used in consumer transactions) ("[A] contractual term which has not been individually negotiated may be regarded as unfair, if contrary to the requirements of good faith, it causes significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.").

88. *See* REPORT ON MEETING HELD IN LOUVAIN-NEUVE FROM 11 TO 13 APRI*l*, *supra* note 84; SUMMARY RECORDS OF MEETING IN ROME HELD 16 TO 20 JANUARY 1989, *supra* note 84; REPORT OF THE STUDY GROUP HELD IN ROME 5 TO 9 APRIL 1982, *supra* note 85.

89. *See* REPORT ON MEETING HELD IN LOUVAIN-NEUVE FROM 11 TO 13 APRIL, *supra* note 84; SUMMARY RECORDS OF MEETING IN ROME HELD 16 TO 20 JANUARY 1989, *supra* note 84; REPORT OF THE STUDY GROUP HELD IN ROME 5 TO 9 APRIL 1982, *supra* note 85.

was superfluous because merchants, usually sophisticated parties, rarely enter into contracts containing terms that are per se grossly unfair.[90]

Ultimately, the two opposing groups reached a compromise.[91] Pursuant to the compromise, they adopted a single article, also entitled "Gross Disparity," which provided that

> (1) [a] party may avoid the contract or an individual term of it if at the time of making the contract[,] the contract or term unjustifiably gave the other party an excessive advantage. Regard is to be had to, among other things, (a) the fact that the other party has taken unfair advantage of the first party's dependence, economic distress or urgent needs, or his improvidence, ignorance, inexperience or lack of bargaining skill, and (b) the commercial setting and the purpose of the contract.
>
> (2) Upon the request of the party entitled to avoidance, a court may adapt the contract or term in order to bring it in accordance with reasonable commercial standards of fair dealing.
>
> (3) A court may also upon the request of a party receiving notice of avoidance[,] providing that party informs the party who sent the notice promptly after receiving it and before that party has acted in reliance on it. The rules stated in Article 3.13(2) apply accordingly.[92]

B. Requirements of Gross Disparity

Under Article 3.10, a party seeking to avoid or modify a contract, or any individual contract term, must demonstrate: (1) a gross disparity between the obligations of the parties which gives one party an excessive advantage over the other, and (2) that this excessive advantage is unjustified.[93] An example of an unjustified excessive advantage would be one which is obtained by exploiting the other party's bargaining handicap. These two criteria reflect a trend in domestic law to consider

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90. *See* REPORT ON MEETING HELD IN LOUVAIN-NEUVE FROM 11 TO 13 APRIL, *supra* note 84; SUMMARY RECORDS OF MEETING IN ROME HELD 16 TO 20 JANUARY 1989, *supra* note 84; REPORT OF THE STUDY GROUP HELD IN ROME 5 TO 9 APRIL 1982, *supra* note 85.

91. *Cf.* UNIDROIT, SUMMARY RECORDS OF MEETINGS HELD IN ROME FROM 16 TO 20 JANUARY 1989, at 40-41, P.C.-Misc. 13 (1989).

92. UNIDROIT PRINCIPLES, *supra* note 3, art. 3.10.

93. *Id.* art. 3.10(1).

procedural and substantive unfairness as distinct but, in most cases, interrelated concepts.[94]

It is important to note that Article 3.10 does not establish a pure mathematical formula to determine whether the performing party may avoid the contract.[95] Instead, a contract may be avoided only where the disparity between the values exchanged is excessive. As explained in the Comments to Article 3.10, "even a considerable disparity in the value and the price or some other element which upsets the equilibrium of performance and counter-performance is not sufficient to permit the avoidance . . . of the contract under this article."[96] Rather, to avoid a contract, the disequilibrium between parties' obligations "must shock the conscience of a reasonable person."[97]

Where one party takes advantage of the other party's weaker bargaining position, the weaker party's dependence must arise independent of the market situation.[98] This requirement may prove problematic, however, when applied to monopolies or oligopolies where the party's weaker bargaining position specifically arises from the market

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94. *See, e.g.*, CO art. 21 (Switz.); C.C. art. 1448 (Italy); ALGERIAN CIVIL CODE art. 90 (Oceana Publications, Inc., Dobbs Ferry, New York 1988) (Alg.); ISRAELI CONTRACTS LAW (General Part); C. CIV. art. 35 (1978). *But see* Decision of May 14, 1991, CASS. CIV. 1991 Recueil Dalloz [D.P.] (giving article 35 direct effect); BW book 3, art. 44(4). *See also* T. Mayer-Maly, Münchener Kommentar § 138 (C.H. Beck'sche Verslagsbuchhandlung 1993) (with respect to German law); Nart v. O'Connor, 1 App. Case 1000 (P.C. 1985) (appeal taken from N.Z.) (with respect to English law); JOHN CARTWRIGHT, UNEQUAL BARGAINING*:* A STUDY OF VITIATING FACTORS IN FORMATION OF CONTRACT (1991).

Even in the United States, with respect to contracts between merchants, courts are more inclined to find unconscionability where elements of both procedural and substantive unfairness exist, notwithstanding the language of the U.C.C. suggesting that a contract or contract term is unenforceable if it is unconscionable per se. U.C.C. § 2-302. *See* Jane P. Mallor, *Unconscionability in Contracts between Merchants*, 40 SW. L.J. 1065 (1986); Fred Briggs Distributing Co. v. California Cooler, Inc., No. 92-35016 1993 WL 306157, at *3 (9th Cir. 1993) ("In order to be entitled to relief . . . [plaintiff] must establish that the contract is unconscionable in both a procedural and substantive sense. . . . Procedural unconscionability consists of an absence of a meaningful choice by one party, while substantive unconscionability occurs when the contract reallocated the risks of the bargain in an objectively unreasonable or unexpected manner.").

95. UNIDROIT PRINCIPLES, *supra* note 3, art. 3.10. Similarly, the traditional rules of Roman law, *laesio enormis*, gave the disadvantaged party an option to rescind the contract if the discrepancy between the values exchanged reached or exceeded the ration of 2 to 1. *See* James Gordley, *Equality in Exchange*, 69 CAL. L. REV. 1587, 1643 (1981). Although adapted these rules still prevail in certain civil codes. *See, e.g.*, C. CIV. art. 1674; C.C. art. 1448.

96. UNIDROIT PRINCIPLES, *supra* note 3, art. 3.10 cmt. 1.

97. *Id.*

98. *Id.* art. 3.10 cmt. 2(a).

situation. More specifically, where one party possesses a dominant position in a given market, the weaker party depends upon the monopolist or oligopolist, leaving no viable alternative but to do business with the dominant party.[99] In turn, the dominant party can easily abuse its position by imposing grossly unfair contract terms. Under Article 3.10, a weaker party has, however, some protection since evidence of grossly unfair contract terms might permit it to avoid the contract.[100] Therefore, where the dominant party (1) obtains an excessive advantage without exploiting the other party's economic dependency and (2) places the weaker party at an unreasonable disadvantage vis-à-vis its competitors, the "dependency" provisions arguably do not apply. In such a situation, the weaker party is protected by those rules prohibiting restrictive trade practices.[101]

In exceptional cases, even where no abuse of a superior bargaining position occurs, a party's advantage may be unjustifiably dependent upon the "nature and purpose of the contract."[102] The validity of a disputed contract or individual terms contained therein depends upon whether they conform to general commercial practice and whether they are similar to other contracts made by parties possessing equal bargaining positions.[103] For example, a term limiting notice of defects of goods or services to an extremely short period of time might be invalid if it advantages the seller or supplier depends on the character of goods or services in question.[104] Similarly, whether a contract restricting trade excessively advantages a dominant party is determined according to the generally accepted trade practices for that respective trade sector.[105]

C. Adaptation Rather Than Avoidance of a Contract and its Terms

A party that enters into a contract creating gross disparity has a right to avoid the contract or to eliminate its individual terms.[106] Articles 3.14 through 3.18 address the various dimensions of this right: (1) the manner in which to exercise the right, (2) the time limit within which to

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99. *Id.*
100. *Id.* art. 3.10(1).
101. UNIDROIT PRINCIPLES *supra* note 3, art. 3.10(1).
102. *Id.* art. 3.10(1) cmt. 2(b).
103. *Id.* art. 3.10(1).
104. *Id.* art. 3.10 cmt. 2(b).
105. *See* CARTWRIGHT, *supra* note 94, at 206.
106. UNIDROIT PRINCIPLES, *supra* note 3, art. 3.10(1).

exercise the right, (3) the effect on the contract where individual terms are voided, (4) the effect on parties' past and future performance, and (5) the innocent party's right to damages.[107]

In the alternative, a court or arbitral tribunal may avoid or modify a contract or its terms so that it adheres to reasonable commercial standards of fair dealing.[108] Although either party—the party entitled to avoidance or the party receiving notice of avoidance—may request modification of the contract, the latter, nonperforming party must promptly inform the former, performing party of its receipt of such notice in order to prevent the former party's reliance on the unmodified contract.[109] If the parties cannot agree as to the procedure to be adopted, the court or tribunal is to decide whether to avoid or adapt the contract; if the contract is adapted, the court or tribunal will also determine which terms are to be modified.[110] Modifying rather than voiding an entire contract permits parties, whenever possible, to preserve the contract and thereby avoids unnecessary expenditure of energies. In international commercial contracts, the ability to modify rather than avoid contracts is particularly advantageous to the parties involved.

V. CONCLUSIONS

Traditionally, parties optimistically assumed that both national and international contracts were negotiated by experienced merchants and competent professionals who generally adhered to well-established principles of fair dealing. However, this assumption has been increasingly called into question for various reasons, including (1) the ever-increasing gaps in the level of education and technical skill of merchants who enter into international commercial contracts and (2) the fact that such merchants are no less likely than any other business person to yield to temptations to exploit weak or dependent parties.

Unlike many other international instruments, the Principles provide for a more realistic evaluation of international commercial contracts, and, at the same time attempt to prevent unfairness by providing various means to police contract formation. The Principles' influence in promoting both procedural and substantive fairness in

107. *Id.* arts. 3.14-3.18.
108. *Id.* art. 3.10(2).
109. *See* UNIDROIT PRINCIPLES, *supra* note 3, arts. 3.10, 3.14, 3.15.
110. *Id.* art. 3.10 cmt. 3.

international trade relationships will depend upon the degree to which parties, courts, and arbitral tribunals adopt and apply its provisions. It is hoped that the approach adopted by the Principles to police contracts will ensure its successful application in the future.