obligations envisaged by the parties. It was suggested that currency clauses should be mentioned in that chapter. Reservations were expressed concerning the appropriateness of the word "hardship" to describe the subject matter of the chapter.

50. There were suggestions concerning the contents and drafting of particular paragraphs of the chapter, which were noted by the secretariat to be taken into account in finalizing the draft chapter.

V. Other business and future work

51. The Working Group noted that the secretariat had now acquired the expertise needed to carry out its new task in a complex area of work. The Working Group expressed its appreciation for the high quality of the work of the secretariat on the sample chapters submitted, which formed a useful basis for the discussions.

52. Concern was expressed that the work should not be delayed. There was general agreement in the Working Group that the Guide should be completed expeditiously. In this connection, the Secretary of the Commission made a statement in which he observed that, as forecast at an earlier stage in the deliberations of the Working Group, half of the available secretariat resources were already devoted to this project. Because of the experience gained in preparing the draft chapters currently before the Working Group, and because of the comments made by the Working Group at this session, the secretariat could to some extent accelerate its work. However, because of the complexity of the work and the need to maintain a high standard, it would be realistic to predict that two to three years would be needed under present conditions for the completion of the project.

53. The Secretary of the Commission also noted that by January of 1984 the secretariat expected to produce sufficient draft chapters to justify the holding of a two-week session of the Working Group. It would therefore be possible to hold the fifth session of the Working Group in New York at the end of January 1984. If this were done, the sixth session could be held towards the end of 1984 in Vienna. Such a course would also expedite the work. After deliberation, the Working Group decided that the date and length of the next session of the Working Group should be fixed by the Commission, as decisions to be taken by the Commission as to the agenda for its sixteenth session were relevant to these matters.

54. At the close of the session, the Working Group expressed its appreciation to its Chairman, Mr. Leif Sevón, for the able manner in which he had conducted the proceedings in this extremely complex field. This had enabled the Working Group to proceed with its work in an efficient and productive manner. It was noted that Finland would cease to be a member of the Commission as from the commencement of the sixteenth session of the Commission, and would accordingly also cease to be a member of the Working Group. The view was expressed that it would be highly desirable if means could be found for Mr. Sevón, despite this fact, to continue to associate himself with the work of the Working Group.

B. Report of the Secretary-General: draft legal guide on drawing up contracts for construction of industrial works: sample chapters* (A/CN.9/WG.V/WP.9 and Add. 1-5)*

[A/CN.9/WG.V/WP.9]

1. At its second session the UNCITRAL Working Group on the New International Economic Order decided to entrust the secretariat with the drafting of a legal guide on contracts for the supply and construction of large industrial works (henceforth referred to as "works contracts") (A/CN.9/198, para. 92). The Commission at its fourteenth session approved this decision by the Working Group and authorized the secretariat to draft the legal guide, which should identify the legal issues involved in works contracts and

suggest possible solutions to assist parties, in particular from developing countries, in their negotiations.¹

2. After having completed its second² and third³ sessions the consideration of a study submitted by the secretariat of clauses used in contracts for the supply and construction of large industrial works (A/CN.9/ WG.V/WP.4 and Add. 1-8 and A/CN.9/WG.V/WP.7 and Add. 1-6), the Working Group suggested that at

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¹The draft chapters prepared at the end of the period covered by the present volume are: chapter II: Choice of contract types (Add.2); chapter XXXII: Exemptions (Add.3); chapter XXXIV: Hardship clauses (Add.4); chapter XXXVIII: Termination (Add.5).
²Referred to in Report, para. 90 (part one, A).
³13 April 1983.
⁴Yearbook ... 1981, part two, IV, A.
its fourth session the draft outline of the structure of the Guide and the approach to be adopted in its drafting should be discussed, and the secretariat was requested to prepare a few sample draft chapters and an outline of the structure of the guide and submit them to the Working Group (A/CN.9/217, paras. 132-133). This decision was approved by the Commission. The present document is submitted in compliance with that request.


4. In drafting these sample chapters the secretariat has taken into account a broad range of relevant documents, contract forms, books and articles. In addition, the secretariat has benefited from the comments of the Ad Hoc Expert Group, which met at Vienna from 14 to 18 February 1983.

5. In the sample chapters reference has occasionally been made to the text of the United Nations Convention on Contract for the International Sale of Goods. Such reference is made solely for the purpose of attaining consistency in approach, whenever appropriate, with the legal text emanating from the work of the Commission.

6. The sample chapters and the draft outline of the structure use the same terminology as that employed in the two studies by the secretariat on clauses related to contracts for the supply and construction of large industrial works (A/CN.9/WG.V/WP.4 and Add. 1-8 and A/CN.9/WG.V/WP.7 and Add. 1-6). It is proposed that in its final form the Guide will have an introduction which will explain the terminology used. It may be advisable to decide on some of the more special terminology at a later stage when considering the draft chapters in which terminology occurs. The terms “purchaser” and “contractor” as well as the term “works contract” have been provisionally retained in the sample chapters and the draft outline of the structure. In the title of the Guide the term “contract for construction” has been used instead of “contract for supply and construction” and the term “large industrial works” has been replaced by “industrial works”. The latter change has been made because the borderline between large and small industrial works may be vague, and the treatment of most issues will be the same regardless of the size of the works.

7. It is possible for certain parts of the Guide to include model clauses which may be recommended for use in certain circumstances. The secretariat, therefore, intends to provide such clauses, whenever appropriate, when the basic approach in these sample chapters is accepted by the Working Group.

[A/CN.9/WG.V/WP.9/Add.1]a

DRAFT OUTLINE OF THE STRUCTURE

Introduction .................................................. 1-4
Draft outline of the structure

1. The secretariat has been requested by the Working Group to submit a draft outline of the structure of the Legal Guide for consideration by the Working Group at its fourth session. The purpose of this outline is to enable the Working Group to decide on the overall contents of the Guide and its structure.

2. In the draft outline, the subject matters dealt with are grouped under two parts. Under part one are grouped subject matters relating to the preparation for contracting, including invitation to tender, negotiation and issues connected with the procedure for the conclusion of contracts. Under part two are grouped subject matters connected with the drawing up of works contracts. The chapters included in that part will indicate the issues that should be settled in works contracts, and suggest possible alternatives for their solution.

3. The order of the subject matters adopted in part two of the draft outline tries to follow, to the extent possible, that found in most work contracts. Furthermore, subject matters concerning the construction phase (chapters IX-XVII) are separated from subject matters concerning the post-construction phase (chapters XVIII-XXI). Subject matters which are common to both these phases are dealt with in chapters XXII-XXI.

4. The most appropriate structure of the Guide, and in particular the most appropriate arrangement of the chapters and their contents, may finally emerge only after an analysis of the issues relating to the various subject matters. The Working Group may, therefore, wish to consider the draft outline as provisional and to give the secretariat a discretion to modify the structure if the need arises.

DRAFT OUTLINE OF STRUCTURE OF LEGAL GUIDE ON DRAWING UP CONTRACTS FOR CONSTRUCTION OF INDUSTRIAL WORKS

Introduction

(Background, lack of experience of contract negotiating and drafting by purchasers from developing countries, context of NIEO-scope and purpose of legal guide, system of and definitions in legal guide, concluding remarks on using legal guide)

PART ONE
PREPARATION FOR CONTRACTING

Chapter I. Feasibility studies
A. Purpose of feasibility studies
B. Responsibility for errors in feasibility studies

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a Yearbook ... 1980, part three, I, B (A/CONF. 97/18, annex I).

Chapter II. Choice of contract type
   A. Introduction
      1. General remarks
      2. Principal elements characterizing nature of contracts to be chosen
         (a) Design
         (b) Co-ordination
         (c) Price
   B. Main types of works contracts
      1. Contract types characterized by allocation of responsibility
         (a) Separate contracts approach
         (b) Turnkey contracts
         (c) Semi-turnkey contracts
      2. Contract types characterized by pricing methods
         (a) Lump-sum contracts
         (b) Cost-reimbursable contracts
         (c) Unit-price contracts
   C. Other factors to be taken into account in choosing contract type
   D. Combination of contract types

Chapter III. Selection of contractors
   A. General remarks
   B. Legal character of parties involved
   C. Joint ventures

Chapter IV. Invitation to tender and negotiation process
   A. Invitation to tender
      1. Form of bidding
      2. Legal effect of invitation to tender
      3. Tender procedure
   B. Negotiation process

Chapter V. Procedure for concluding contract
   A. General remarks
   B. Form of contract
   C. Validity of contract

PART TWO
DRAFTING CONTRACTUAL PROVISIONS

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Chapter VII. Determination of contract parties

Chapter VIII. Definitions and interpretation
   A. Definitions of key contract terms
   B. Contract provisions on interpretation

Chapter IX. Scope and quality of works
   A. Determination of scope and quality of works in contract provisions

Chapter X. Supply of equipment and materials to be incorporated into works
   A. Scope of obligation to supply equipment and materials
   B. Place of supply and obligation to provide transport
   C. Take-over of equipment and materials

Chapter XI. Storage on site
   A. Responsibility for storage
   B. Access to storage facilities

Chapter XII. Erection of plant
   A. Erection by contractor
      1. Preparatory work
      2. Materials needed for erection
      3. Responsibilities of parties
   B. Supervision of erection by contractor
   C. Access to works
   D. Labour and working conditions
   E. Contractor’s equipment

Chapter XIII. Inspection and tests
   A. Inspection of equipment and erection
      1. Inspection during production
      2. Inspection of supplied equipment
      3. Inspection of erection
   B. Performance tests
      1. Time for performance tests
      2. Procedure for performance tests
      3. Obligation of purchaser concerning performance tests
4. Protocol on performance tests  
5. Effect of performance tests  
6. Effect of unsuccessful performance tests

C. Cost of inspection and tests

Chapter XIV. Completion, take-over and acceptance of works
A. General remarks
B. Completion of works  
   1. Time for completion  
   2. Time schedule for construction and completion  
   3. Extention of time for completion
C. Take-over of works  
   1. Preconditions for take-over  
   2. Postponement of take-over  
   3. Legal effect of take-over
D. Acceptance of works  
   1. Preconditions for acceptance  
   2. Act of acceptance  
   3. Acceptance of part of works  
   4. Presumed acceptance  
   5. Legal effects of acceptance

Chapter XV. Price
A. General remarks
B. Method of pricing  
   1. Fixed price  
   2. Pricing on basis of time incurred on work done  
   3. Reimbursable price  
   4. Bonus payment  
   5. Price currency
C. Revision of price  
   1. Currency clauses  
   2. Inflation clauses
D. Payment conditions  
   1. General remarks  
   2. Time of payment

Chapter XVI. Co-operation and liaison agents
A. Extent of co-operation by parties  
B. Co-ordination of performances  
C. Co-ordination procedure  
D. Powers of liaison agents  
E. Construction manager

Chapter XVII. Consulting engineer
A. Function of consulting engineer
B. Legal position of consulting engineer  
   1. Engineer as purchaser’s representative  
   2. Engineer chosen by both parties

Chapter XVIII. Management services
A. Scope of management services

Chapter XIX. Price and other contractual terms
B. Price and other contractual terms  
C. Responsibility of contractor

Chapter XX. Maintenance and repairs
A. Scope of maintenance and repairs  
B. Price and other contractual terms  
C. Responsibility of contractor

Chapter XXI. Technical advisory services
A. Scope of advisory services  
B. Price and other contractual terms  
C. Responsibility of contractor

Chapter XXII. Spare parts
A. General remarks  
B. Scope of obligation of contractor  
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Chapter XXIII. Transfer of technology
A. Transfer of technology in connection with construction of work  
   1. Scope of transfer  
   2. Ownership of technology to be transferred  
   3. Confidentiality  
   4. Infringements of third person’s rights
B. Transfer of technology after completion of works  
   1. Transfer of new technology by contractor  
   2. Retransfer of new technology by purchaser

Chapter XXIV. Training
A. Training before completion of works  
B. Training after completion of works  
C. Scope of training  
D. Time and place of training  
E. Cost of training  
F. Responsibility of training

Chapter XXV. Passing of risks
A. General remarks  
B. Passing of risks in connection with construction of works  
   1. Time of passing of risks  
   2. Excepted risks  
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B. Property in equipment and materials to be incorporated into plant  
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Part Two: Studies and reports on specific subjects

Chapter XXVI. Insurance
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B. General insurance clauses
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1. Property insurance
2. Liability insurance
D.Proof of insurance
E. Consequences of failure to provide insurance

Chapter XXVII. Customs duties and taxes
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1. Customs duties concerning equipment and materials to be incorporated into works
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1. Possibility of subcontracting
2. Selection of subcontractors
3. Compatibility of subcontracts with main contract
4. Payment for subcontracted supplies
B. Procurement by contractor on behalf of purchaser
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B. Guarantees
1. Performance guarantees
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C. Security interests
D. Retention
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Chapter XXX. Failure to perform
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1. General remarks
2. Delay by contractor in course of construction
3. Delay by contractor in completion of works
4. Delay by purchaser in taking over equipment or materials to be incorporated into works
5. Delay by purchaser in procuring materials or services or granting construction facilities
6. Delay by purchaser in erection to be supervised
7. Delay by purchaser to take over works
8. Delay by purchaser in payment
B. Defective construction
1. General remarks
2. Defects during production and construction
3. Defects of works and taking over
4. Defects of works during guaranty period
5. Procedure for claims
C. Failure to perform other obligations
1. In connection with construction of works
2. In connection with supplies after completion of works
D. Contractor's liabilities in respect of third parties employed for performance

Chapter XXXI. Damages
A. Obligation to pay damages
B. Limitation of damages
1. Unforeseeable damage
2. Indirect loss
3. Damage caused by defects of materials provided or design stipulated by purchaser
4. Failure to mitigate loss
C. Personal injury and damage to property not a subject of contract

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B. Exemption clause and applicable law
C. Impediments covered by exemptions
D. Notification of impediments
E. Legal effects of exemptions

Chapter XXXIII. Liquidated damages and penalty clauses
A. Purpose of clause
B. Breach of contract covered by clause
C. Sum to be paid
D. Effect of exempting impediments
E. Relationship to performance
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G. Possibility of reduction

Chapter XXXIV. Hardship clauses
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B. Factors to be considered as to whether to include hardship clause
C. Approach to drafting hardship clause
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Chapter XXXV. Variation
   A. General remarks
   B. Variation by mutual agreement
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   D. Legal effects of variation

Chapter XXXVI. Assignment
   A. Transfer of contract
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Chapter XXXVII. Suspension of contract
   A. General remarks
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Chapter XXXVIII. Termination of contract
   A. General remarks
   B. Extent of termination
   C. Grounds for termination
   1. Unilateral termination by purchaser
      (a) Breach of contractual obligation by contractor
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      (c) Termination for convenience
      (d) Other grounds
   2. Unilateral termination by contractor
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      (b) Bankruptcy or insolvency of purchaser
   3. Prevention of performance due to exempting impediment
   D. Procedure for termination
      1. Time for termination
      2. Notice
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   E. Rights and duties of parties upon termination
      1. Cessation of work by contractor
      2. Completion of work by purchaser
      3. Use and disposition of contractor's equipment and materials
      4. Assignment of third parties' contracts and assumption of liabilities
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[A/CN.9/WG.V/WP.9/Add.2]a

CHAPTER II. CHOICE OF CONTRACT TYPE

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a13 April 1983. Referred to in Report, para. 90 (part one, A).
A. Introduction

1. General remarks

1. The purchaser who wishes to construct industrial works may proceed in various ways. He may enter into several contracts dealing with various aspects of the project, such as contracts for design, civil engineering, sales contracts for the supply of equipment and materials, contracts for erection of the plant, consulting contracts and licensing contracts. Alternatively, the purchaser may conclude works contracts, i.e. contracts of a more comprehensive nature, comprising many or all aspects of the construction such as design, delivery of equipment and materials, erection of plant, civil engineering, building construction and transfer of technology.

2. Where the purchaser chooses to use a works contract he may use a single contract in which only one contractor is responsible for all the necessary steps of the works construction. Alternatively, the responsibility for construction can be divided among various contractors under two or more works contracts, to which may be added one or more contracts of the types mentioned in paragraph 1, above. Co-operation by the purchaser and his participation in the construction is usually required under all types of works contracts. He is usually expected to provide a site for the construction, he often supplies the contractor with power and water needed for the construction and he is usually obligated to procure all permits and authorizations needed for the construction under the law of the place of construction.

3. A works contract can be expected to contain, as a basic minimum, two composite elements of varying degrees of value and importance, i.e. erection at the site (often involving the supply of materials), and supply of equipment, manufactured elsewhere prior to delivery and erection at the site. In some cases the manufacture contemplated may use relatively common technology, which is available from a number of competing sources and may even be designed by the purchaser’s personnel or consultants. Where highly complex technology is to be used, there may be an element of specialization or exclusiveness involved, which may require a much higher degree of control over the construction by the contractor, balanced by an assumption on his part of considerable design and performance obligations if the purchaser is to receive proper protection of his interest. In addition, a contractor may assume post-completion obligations relating for example to the provision of spare parts, technical maintenance and repairs of works.

2. Principal elements characterizing nature of contract to be chosen

4. A purchaser contemplating a project for industrial works should, as a matter of broad principle, first make a careful analysis of his own needs and of the project’s various constituent parts with a view to determining the best contractual arrangements for three essential elements of the works contract: the design of the works, co-ordination of the construction process and the price.

(a) Design for plant and erection

5. One of the most important issues to be settled in connection with the choice of contract type relates to determining what contractual arrangements should be made for the design. On the one hand, a single contractor may be employed to design and construct the whole project, or a number of contractors employed under separate contracts, in which some or all of the contractors may be required to assume the responsibility for the design and suitability for the intended purpose of their own work or equipment. On the other hand, the purchaser may employ independent design professionals, or use his own technical employees, with the contractor or contractors being responsible only for performance in strict accordance with the purchaser’s or his professionals’ designs and specifications and not (in the absence of poor workmanship or materials) for the subsequent performance or suitability of the works or equipment after completion.

6. The contractual arrangements concerning the design are particularly relevant in connection with the allocation of the responsibility for the proper functioning of the works. Only in cases where the construction is to be executed by a single contractor on the basis of a design supplied by him is the responsibility not allocated between two or more contractors or suppliers. Even in cases where the plant is to be delivered and erected by a single person but under a design supplied by a different party it may be difficult for the purchaser to prove whether the designer or the contractor is liable for the failure of the works to operate (see paragraph 13, below).

7. In regard to some types of works, a class of design professionals may not be available to design the plant, and both the design and equipment will, as a commercial reality, have to be obtained from a contractor. Thus, the equipment for a power station or a hydro-electric dam, or the entire layout and equipment of a cement plant or sugar-mill or factory, is likely to be both designed and supplied by an experienced industrial manufacturer. In such a case the purchaser is compelled to rely on the contractor for the design of his product, and it will be of the essence of the contractor’s responsibility that he will in such a situation (independently of any question of fault on his part) be responsible for the product’s suitability for its required purpose. Even when such a contractor is employed, his design competence may not extend to some parts of the plant or equipment (e.g. lifts) and separate design professionals may be needed to design such parts of the plant or equipment.

8. In the field of erection, experienced design professionals may be available. Their skill might lie in evolving the best design to meet the limitations of a particular site and the special need of the purchaser. However, it may be noted that even if the erection is to be designed by a design professional, there may be other parts of the project which may be outside the expertise of such a professional and may need to be designed elsewhere. This erection design can either be provided by sub-consultant professionals working in collaboration with the principal design professional (where such a class of specialist sub-professionals exist, as, for example, in heating and ventilation) or else under separate contracts by contractors responsible for the design and performance of the equipment delivered by them.
(b) Co-ordination

9. Another issue to be settled is the arrangement to be made for the co-ordination of the various elements of the construction process, and determining who is to be responsible for such co-ordination. Co-ordination may be entrusted to one comprehensive contractor (with or without selected subcontractors or suppliers) or the project may be subdivided into separate contracts concluded by the purchaser, with the purchaser undertaking necessary co-ordination.

(c) Price

10. The purchaser, having determined the best arrangements for design and the co-ordination of responsibilities, should deal with the issue of the arrangements to be made for the price. The settlement adopted on the issues of design and co-ordination will strongly affect the pricing arrangements to be adopted (see paragraph 75, below). The amount of the price is influenced by the extent of risk to be borne by the contractor. The greater the risk that he must bear the higher the price will be, since the contractor must pay to insure against such risks or provide financial reserves to cover them. For these reasons the price for the same scope of construction is usually higher in the turnkey approach than in the semi-turnkey approach, and in the semi-turnkey approach than in the separate contracts approach.

B. Main types of works contracts

11. Various types of works contracts are used in international trade practice. The two most important methods of classifying them are on the basis of the allocation of responsibilities for the construction and on the pricing method used by the parties.

12. The main types or approaches to works contracts based on the allocation of responsibility are “separate contracts”, “turnkey contracts” and “semi-turnkey contracts”. Under separate contracts the construction obligations are allocated to two or more contractors and each of them is responsible only for supplies of equipment, materials and services entrusted to him under the terms of the contract. The design would usually be supplied by a design professional. The purchaser bears the principal responsibility for co-ordinating the contents and execution of the separate contracts (see paragraphs 18-27, below). Under a turnkey contract in principle a single contractor undertakes the responsibility for the entire construction of the works including the design and assumes the responsibility for co-ordinating all aspects of the construction process as to enable the works to be completed in time and to be able to operate in accordance with the contract (see paragraphs 28-40, below). Under semi-turnkey contracts the semi-turnkey contractor, although he does not undertake the entire construction, is responsible for putting the whole works into operation in the same way as a turnkey contractor. However, he can avoid liability for any failure of the works by proving that such a failure is due to a failure relating to the part of the construction not covered by the semi-turnkey contract. Such part may be entrusted to another contractor or undertaken by the purchaser himself (see paragraphs 49-53, below).

13. Some elements of both the separate contracts approach and turnkey contract approach may be found in a comprehensive works contract under which a single contractor undertakes to construct the whole works in accordance with a design supplied by another party. Under such a contract the co-ordination liability for construction is assumed by the contractor as in a turnkey contract, but in contrast thereto the responsibility for a failure of the works to operate is allocated between the comprehensive contractor and the designer. If the works are incapable of operating as foreseen, it may be difficult for the purchaser to prove whether this failure has been caused by an error in the design or by a defect in the equipment or its installation (see paragraph 26, below).

14. The main types of works contracts classified on the basis of the pricing method used by the parties are “lump-sum contracts”, “cost-reimbursable contracts” and “unit-price contracts”. The term “lump-sum contracts” (or “fixed-price contracts”) is usually used for contracts in which the agreed price is not subject to any price revision if there is an increase or decrease, after the contract is made, in the costs of construction (due to a change in the price of construction materials, or in the quantities of work to be done over the estimates made at the time of contracting), unless there is a price revision clause in the contract. Under “cost-reimbursable contracts” the contractor is entitled to be paid whatever the execution of the contract costs him, and in addition to claim a fee. Under “unit-price contracts” a determined price is to be paid for a defined unit of work and the price to be paid will vary with the quantities of work performed.

15. The denomination of various types of works contracts is, however, not uniform and different terminology is used in practice. In addition, only exceptionally is a single pricing method used in a contract, and in many contracts various pricing methods are combined, although one of them is usually dominant.

16. Choosing an appropriate type of works contract is a complex and difficult undertaking. The parties should, accordingly, consider the types of contract described below, and the allocation of responsibilities and the pricing methods that they involve. While parties are free to modify these types to meet their particular needs, care should be taken that such modifications do not create inconsistencies in the rights and obligations of the parties. Furthermore, if a certain type of contract is used, it may be advisable to settle certain issues (e.g. passing of risks, insurance, payment conditions) in a particular way. In any event, the contract should be very clear in the stipulation of the rights and obligations of the parties. If the parties expressly denominate a contract (e.g. “turnkey contract”) but are unclear as to the stipulation of the rights and obligations of the parties, this denomination may be relevant in interpreting its effect.

17. The following is a brief description of the major types of works contracts classified above. Certain aspects of these types of contracts are dealt with in detail in other chapters of the Guide.

1. Contract types classified by allocation of responsibilities

(a) Separate contracts approach

18. Construction obligations may be allocated to two or more contractors on the basis of separate contracts concluded by the purchaser with them.2 The purchaser may himself undertake part of the construction.

2 The term “separate contracts” is now widely used. However, in contrast to the terms “turnkey contract” and “semi-turnkey contract”, it gives no indication of the nature of the contractor's responsibility. In the typical form of the separate contracts approach considered in this section, the responsibility for construction is allocated among several contractors. The use of a partial turnkey contract (see paragraph 41) or a semi-turnkey contract (see paragraph 49), may also involve separate contracting, but in these cases the responsibility for construction rests mainly on the partial turnkey or semi-turnkey contractor.
19. Each of these contractors is responsible only for supplies of equipment, materials and services entrusted to him under the terms of the contract. The contract only requires that the equipment, materials or services to be supplied by each contractor conform with specifications in his contract; it does not impose a liability on the contractor if the purchaser fails to attain a construction target anticipated by the purchaser in using the equipment, materials or services. The purchaser will thus have to bear the financial consequences of a failure to achieve a construction target unless he proves that the failure was caused by a non-conformity of a contractor with his contractual obligations. Since the construction is divided among two or more contracts, the purchaser bears the principal responsibility of co-ordinating the contents and execution of these contracts in order to achieve the construction target.

20. The ways in which the works construction is to be divided among various contractors and the purchaser may depend in particular on the nature and size of the works and on financial considerations. Separate contracts are sometimes concluded for the supply and erection of various parts of equipment on the one hand, and for the building and civil engineering on the other hand. The erection of the equipment is, however, in many cases effected by the purchaser's personnel or by a local enterprise and the foreign contractor only supervises the erection.

21. Under the separate contracts approach, the design on the one hand, and construction and deliveries of equipment on the other, are often separated. The purchaser may employ a specialized design office or a consulting engineer or a construction manager to carry out the design, or it may be done by the purchaser's staff. The separate contracts approach may be advisable where different design sources have to be used for different parts of the project (see paragraphs 4-8, above). This approach may also be appropriate where no single principal contractor can be found having the expertise to undertake all parts of the project, or to supervise parts of the construction entrusted to subcontractors.

22. The main disadvantage of the separate contracts approach for the purchaser is that he assumes the risks connected with a failure to co-ordinate the construction of the works, such as a delay in the works construction as a whole (for example, postponement of erection of the equipment to be effected by one contractor due to a failure to complete building construction in time by another contractor), and a failure to achieve construction targets. If the works fail to operate, the purchaser must prove which contractor is responsible for the works' failure. Since there are complex and interrelated performances by several contractors, this may be extremely difficult.

23. If a failure to perform by one contractor has repercussions on the work of the others, the purchaser may be liable to pay damages for any resulting loss to the others provided that they have performed or were ready to perform their contractual obligations. The purchaser may, however, be entitled to penalties or liquidated damages or to be indemnified for these damages by the contractor who was responsible for the failure. The possibility of legal action against the contractor who has failed to perform his obligation to recover damages paid to other parties, may, however, be limited by the contract or the applicable law. Even when there is a special clause providing such a right to the purchaser, damages may be limited in the contract to an agreed sum and this may result in the purchaser having to bear some portion of the damages which other contractors have recovered from him.

24. Under the separate contracts approach, the purchaser usually retains control over the construction and has more flexibility in making changes in the scope and manner of the construction than when all construction obligations are integrated within a single contract and only one contractor bears responsibility for the work. In general, the smaller the size of the works the easier it is for the construction to be divided into a small number of separate contracts and for the purchaser to co-ordinate their contents and execution. The risks connected with co-ordination increase when a large number of contractors or other parties participate in the construction. In respect of major works or projects involving a complex technology the separate contracts approach should be used only if the purchaser has a well-established engineering department which is experienced in such co-ordination or if he can employ a reliable consulting engineer or other consultant for the purpose of co-ordinating and controlling the construction process.

25. The risks borne by the purchaser in connection with the co-ordination of the contents and execution of separate contracts may be reduced by employing a construction manager, sometimes called a managing contractor. The construction manager may be the designer of the works. Whether or not he is the designer his responsibility need not be limited to giving advice, but may include integrated construction management, i.e. planning, inviting tenders and negotiating separate contracts for the various sections of the works, concluding such contracts for and on behalf of the purchaser, co-ordination of all site activities and supervision of the construction. If the design is undertaken by other parties, the purchaser may wish to employ as construction manager a firm with design capabilities, and to give it the responsibility to check the design and to discover errors therein, and to specify the standard of testing which the firm has to exercise. The scope of the obligations of a construction manager is broader than that of a consulting engineer or a consultant; but it is more limited than that of a turnkey contractor (see paragraphs 28-29, below), since the construction manager concludes contracts with various contractors participating in the construction only for and on behalf of the purchaser. The construction manager may, however, be responsible under the contract for the appropriate selection of these contractors. A fixed fee is usually paid for the services of a construction manager, which is usually higher than the fee of a consulting engineer or consultant because of the broader scope of the construction manager's obligations. The parties may agree that the fee is to be reduced if the works are completed late or if the cost of the construction is higher than envisaged, and increased if the works are completed early or the cost is less than envisaged.

26. Employing an independent professional for design has the advantage of enabling such a designer to supervise the works construction and to check whether the construction technique meets the design requirements and specifications. On the other hand, if the works are found to be incapable of operating as intended, it may be difficult for the purchaser to prove that this failure was due to an error in the design and not to a defect in the equipment or its erection, or vice versa. This risk of the purchaser may be reduced by stipulating in the contract that the contractor is obliged to inform the

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4See Guide on Drawing up Contracts for Large Industrial Works (United Nations publication, Sales No. E.73.II.E.13), para. 4.

5Ibid., para. 14.

6See chapter "Consulting engineer".

7See chapter "Co-operation and liaison agents", section E "Construction manager".
purchaser of evident errors in the design of equipment to be supplied by the contractor. A disadvantage of employing an independent professional for design is that he may be unable to achieve manufacturing and construction economies which a contractor undertaking both design and supply could achieve (see paragraph 35, below).

27. Purchasers from developing countries are generally interested in the employment of their nationals as contractors to the greatest extent possible. The purchaser may attempt to employ local contractors for the construction of some parts of the works under the technical direction and control of experienced foreign contractors employed for another part of the construction. This approach may save foreign exchange and transfer technical and managerial skills to local firms in the purchaser’s country. The respective responsibilities of the local contractors and of the foreign contractor should be clearly stipulated in the contracts concluded by the purchaser in order to avoid disputes and difficulties later.

(b) Turnkey contracts

(i) Pure turnkey contracts

28. Under the pure form of a turnkey contract (sometimes called “total turnkey contract”) a single contractor takes responsibility for the entire construction of the works, and his obligations normally cover the design, the supply of drawings and other documentation, the supply of equipment and materials to be incorporated in the works, civil engineering, building construction, transfer of technology, putting the works into operation and handing over to the purchaser the works capable of operation in accordance with the contract terms. In short, the contractor’s responsibility covers the design and all other steps of the construction up to the “turning of the key” by the purchaser to start the operation of the works.7

29. Under pure turnkey contract terms all items of work needed for the completion and appropriate operation of the works in accordance with the contract, even if not expressly provided in the contract specifications of equipment or services, must be supplied by the contractor and are considered to be covered by the scope of the contract. If the turnkey contractor fails to perform his obligation to complete the works and put it into operation, he can avoid liability to pay damages only by proving that his failure was caused by a failure on the part of the purchaser to perform a contract obligation, or by exempting impediments.8

30. The integration of the works construction under a single turnkey contract means that there is only one contractor responsible for the completion and putting into operation of the works in accordance with the contract. In most cases, however, a turnkey contractor will be unable to supply all equipment, materials and services himself and will have to employ subcontractors. However, his liability will not be reduced by employing such subcontractors and he will be responsible not only for his own failure to perform but also for failures of his subcontractors.9

31. The contractor assumes vis-à-vis the purchaser the responsibility for co-ordinating all deliveries and work needed to complete the construction in time and without any defects, and he bears the consequences of any discrepancy between his responsibility arising from the turnkey contract and the separate responsibilities he has placed on his subcontractors. Thus, with a turnkey contract the purchaser passes on to the contractor the duty to co-ordinate and the risks arising therefrom which are borne by the purchaser under the separate contracts approach.

32. Depending on the character of the works to be constructed either the owner of the technology or the main supplier is frequently selected as the turnkey contractor. Such persons usually have experience of works construction and the problems of co-ordination.

33. The main advantage of the pure turnkey contract approach is that, if the works fail to operate as stipulated in the contract, the purchaser will not be concerned to discover whether the failure is due to defective design on the one hand or defective equipment, installation or materials, on the other. In addition, in case of an inadequacy of the design the financial resources of a turnkey contractor available to meet the purchaser’s claim will in many cases be greater than those of a professional designer.

34. The turnkey contract approach is advisable if the purchaser does not have the management resources needed to adopt successfully the separate contracts approach (see paragraphs 22-25, above). The turnkey contract approach may be useful in developing countries in the early stages of industrialization when local technological capabilities are limited and when it is therefore important to ensure that total responsibility for setting up the works and putting them into operation is entrusted to a contractor having the needed experience in the field involved. In particular, specialized high technology and manufacturing process projects may dictate the use of the turnkey approach, due to the absence of any available class of consultant to provide the essential design.

35. As a turnkey contract can be awarded after competitive bidding, the turnkey approach enables the purchaser to obtain the benefit of competition in respect of the project design which under the separate contracts approach is usually carried out by a design office or consultant or the purchaser’s staff. The separate designer may tend to overdesign and his contract may become, therefore, more expensive. In addition, the design produced by a turnkey contractor is likely to reflect potential manufacturing or construction economies which are specifically known only to the turnkey contractor. Such a design can be arrived at taking full account of construction problems, and it should offer both saving in costs and speedier construction. The possibility of design economy may vary with the nature of the works to be constructed.

36. However, in addition to having to pay a high price to the contractor to compensate him for bearing the risks mentioned above, there are a number of other possible problems connected with the turnkey approach.

37. There can be little check on the reasonableness of the turnkey price as it is difficult to make any genuine assessment or comparison of prices between contractors where their designs differ. If, for example, a project is put to tender with the purchaser’s outline requirements specified, the result may be a competition in under-design, with considerations of long-term life and quality, and simplicity of maintenance, sacrificed to offering an apparently attractive price. If a thorough checking of the turnkey contractor’s design is attempted by employing independent professionals, the costs may substantially increase and the design economy of the turnkey contract approach may be lost. In addition, if the purchaser wishes to use the turnkey contract approach under competitive

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7See UNIDO, "Features and issues in turnkey contracts in developing countries" (ID/WG.337/5), para. 7.
8See chapter "Exemptions".
9Ibid.
tendering procedures, the cost of tendering is increased since all contractors will have to engage design or consultant personnel to prepare and submit the competing designs, and the design costs of the unsuccessful tenders will, in the long term, need to be recoverable in the prices of their successful tenders.

38. By concluding a turnkey contract the purchaser places himself entirely in the hands of the turnkey contractor. Accordingly, an appropriate selection of the contractor is of vital importance for the purchaser, and he may often need professional advice on the technical qualifications and financial ability of the turnkey contractor under consideration.

39. The turnkey contractor may insist on the right to select subcontractors since he will be liable for their failures of performance (see paragraph 30, above). However, it should be noted that in some countries the supply of certain equipment, civil engineering or various services may be reserved for firms in these countries if the works are to be constructed there.

40. By placing the construction responsibility upon one contractor the purchaser loses, at least to some extent, control over detailed engineering, since the contractor usually wishes to be given authority to make decisions on the methods of construction. The purchaser faces the risk that the turnkey contractor, who is paid a lump sum, will be guided in his decisions on detailed design, selection of subcontractors and construction methods only by the desire to reduce his costs, and that he may not take into account factors such as the long-term life and reliability of the works which would guide a consulting engineer.

(ii) Partial turnkey contracts

41. The parties may limit the scope of the turnkey contract to the construction of the main technological process for which special knowledge is needed and exclude from it ancillary buildings (such as administrative buildings or other facilities) or even a technological unit not forming an integral part of the main technological process. This kind of turnkey contract is sometimes called a "partial turnkey contract" and is often used in cases when the turnkey contractor is a foreign enterprise and the ancillary buildings or technological units not forming an integral part of the main technological process can be constructed by local contractors. The separate contracts approach may be adopted for the parts of the construction excluded from the turnkey contract.

42. The partial turnkey contractor is responsible for the construction of the main technological process covered by his contract to the same extent that a pure turnkey contractor is responsible for the construction and putting into operation of the works as a whole. The distinction between the two types lies, therefore, in the scope of the respective contracts and not in the nature of the contractor's responsibility. In using a partial turnkey contract the purchaser must undertake some co-ordination, as when he uses the separate contracts approach (see paragraph 19, above), but only to a very limited extent. If he fails to co-ordinate the work, and, for example, construction under the partial turnkey contract is completed before the completion of the ancillary facilities, he may be obligated to bear unnecessary expenses in paying a bonus price for an earlier date of completion without being able to start the operation of the works at that earlier date. In principle, the partial turnkey contract has, in respect of the portion of the construction covered thereby, the same advantages and disadvantages as the pure turnkey contract has in respect of the entire works construction.

(iii) Product-in-hand contracts

43. The product-in-hand contract is usually considered to be a kind of turnkey contract. Its use in practice has been limited. Under the product-in-hand contract (the French term "produit en main" contract is often used in practice) the contractor has all the responsibilities of the turnkey contractor, but also has additional responsibilities after the stage of startup of the works for a specified period of initial operation of the works.

44. The product-in-hand contract entails the widest responsibility of the turnkey contractor, since he must not only complete the works so that they are capable of producing products of the quality and quantity stipulated in the contract, but he must also enable the purchaser to operate the works and achieve the production targets with the purchaser's own staff. The contractor is obligated to direct production and management of the works during an agreed test period, and the final take-over of the works occurs only after the works have been successfully operated during such a test period with the purchaser's own staff and by using raw materials and other materials which the purchaser would use.

45. In the pure turnkey contract the contractor's responsibility does not extend to the successful functioning of the works after the test acceptance has been completed, and even if the contractor guarantees performance the guarantee is limited only to the curing of technical defects in the works arising during the guarantee period. The pure turnkey contractor does not guarantee the successful operation of the works by the purchaser's staff. This legal situation is basically the same even when the contractor is obligated to train the purchaser's staff, for, while he is liable to give appropriate training, he does not guarantee the acquisition of the knowledge needed to operate the works.

46. The purchaser's staff to be employed in operating the works must be trained and placed on the job under the product-in-hand contract by the contractor who is responsible for the results of his training. In addition to training, the contractor is responsible also for testing and placement of the purchaser's staff within the works, and organization of their activities, and for continuous on-the-job training according to the agreed schedules. The product-in-hand contract, therefore, requires some transfer to the purchaser of management skills needed for the operation of the works.

47. In the product-in-hand contract the purchaser is protected to the maximum possible extent, since all the risks of the failure of the works to operate successfully during the agreed period of time are borne by the contractor. If the works' output target is not achieved the contractor is relieved from liability to pay damages only by proving that the failure was due to exemplifying impediments. The price in a product-in-hand contract may, therefore, be considerably higher than in a pure turnkey contract.

48. In general, the product-in-hand contract has all the advantages and disadvantages of the pure turnkey contract. In addition, the purchaser is assured of being able to operate the works himself. On the other hand, the ability of the purchaser to select personnel for the works may be limited as the contractor may insist on his own choice of suitable persons to be trained.

(c) Semi-turnkey contracts

49. In practice a type of contract (sometimes called "semi-turnkey contract") is used which can be considered an

10Ibid.
intermediate step between the separate contracts approach and a turnkey contract. Under this approach, the purchaser concludes a contract with a supplier of design, equipment, materials, technology and services (the semi-turnkey contractor) for the major part of such supplies needed for the works construction, and separate contracts with other parties for supplying the equipment, materials or services not included in the semi-turnkey contract. Like the turnkey contractor, the semi-turnkey contractor is responsible for putting the whole works into operation and handing over to the purchaser the works capable of operation in accordance with the contract terms. The semi-turnkey contractor can, however, avoid liability for any failure of the works by proving that such failure is due to failure to perform the separate contracts relating to that part of the construction excluded from the scope of the semi-turnkey contract.11

50. This approach may be useful in cases where the functioning of the part of the technological system to be excluded from the scope of the works contract with the main contractor is closely linked with the functioning of the rest of the system to be constructed by the main contractor (for example, the semi-turnkey contractor to supply and erect a power station, and the other contractors to supply the valves and tubing for the power station). Since the design of the works would be the responsibility of the semi-turnkey contractor he would be obligated to inform the purchaser of the specifications of the equipment, materials or services to be supplied under the separate contracts. A purchaser who wishes to obtain still greater security may obligate the semi-turnkey contractor to check that the performance of the separate contractors is in accordance with specifications or with a time schedule provided by the semi-turnkey contractor.

51. Like the partial turnkey contractor, the semi-turnkey contractor undertakes only part of the construction. However, while the partial turnkey contractor only assumes responsibility for the part of the construction which he undertakes, the semi-turnkey contractor assumes responsibility for the whole construction, subject to his power to avoid liability in the circumstances noted (see paragraph 49, above). In respect of the part of the construction which he undertakes the partial turnkey contractor is solely responsible and cannot place responsibility on other contractors (see paragraph 41, above).

52. The semi-turnkey contract may in some cases offer advantages over both the turnkey contract approach and separate contracts approach. Where the purchaser uses the separate contracts approach, and a failure of the works occurs, he may have difficulty in establishing which contractor's default caused the failure. Under the semi-turnkey approach, the purchaser will in the first instance hold the semi-turnkey contractor responsible for all failures of the works; if the semi-turnkey contractor avoids liability in the manner indicated above, the purchaser will have the evidence which may be used to establish the responsibility of one or more of the separate contractors.

53. Another advantage for the purchaser in a semi-turnkey contract over the separate contracts approach is that the design of the works and supplies of main equipment are usually integrated in one person which could result in manufacturing and construction economies. Further advantages are that the purchaser maintains complete freedom to select suppliers of parts not covered by the semi-turnkey contract, and that the responsibility for co-ordination imposed on the purchaser is of a limited extent (cf. paragraph 19, above). The main advantage for the semi-turnkey contractor is that, while he is responsible for construction and for putting the works into operation, his responsibility (in comparison with the pure turnkey contractor) is limited by his ability to prove that the failure of the works to achieve performance objectives was due to defects in parts of the works not covered by the semi-turnkey contract.

2. Contract types classified by pricing method

(a) Lump-sum contracts

54. A lump-sum contract is a contract whereby the contractor agrees for a price fixed in a lump sum to perform the obligation set forth in the contract, which may sometimes consist of the entire construction of the works. The term lump-sum contract is also used where the various obligations to be performed are divided in the contract and a separate sum is fixed as the price for each set of obligations. The lump sum is the aggregate of the separate sums.12 Sometimes the term "fixed-price contract" is used for this kind of contract.

55. In a lump-sum contract the contractor takes the risk of being able to perform for the specified amount and he cannot obtain any price revision if there is an increase in the costs of performance after the conclusion of the contract unless there is a price revision clause in the contract.

56. The contractor may, however, be entitled under the contract or applicable law to an equitable adjustment of the price in the event that his costs are increased by changes required by the purchaser after the conclusion of the contract or by a necessary modification needed to the scope of the work, provided the contractor is not responsible for the circumstances making the modification necessary.13 The precise extent of work which the contractor must do for the lump sum should be defined in the contract.

57. The lump-sum or fixed-price method is often used in pure turnkey contracts, but it may also be used in other types of contracts (i.e. separate contracts or semi-turnkey contracts), in particular in fixing the price for the supply of equipment and materials, the granting of licences and know-how, civil engineering, procurement services and inspection services.14

58. The contractor's profit, if any, is realized by the difference between the fixed price agreed upon in the contract and the cost of construction incurred by him. In calculating the fixed price the contractor usually includes an amount additional to estimated costs and profits in order to cover the risk of an increase in costs.

59. As the fixed price is, in general, to remain firm even if the performance entails more costs for the contractor than he anticipated at the time he concluded the contract, the fixed price method is usually provided in cases where significant changes in the scope of the works are not envisaged.

(b) Cost-reimbursable contracts

60. Cost-reimbursable contracts are sometimes also described as cost contracts, cost-plus contracts, prime-cost contracts. For this approach see "UNIDO model form of turnkey lump-sum contract for the construction of a fertilizer plant" (UNIDO/PC. 25), art. 20.

61. See chapter on "Scope and quality of works".

62. Under the "UNIDO model form of cost-reimbursable contract for the construction of a fertilizer plant" (UNIDO/PC. 26), art. 20, a fixed price is to be stipulated for licences and know-how, procurement, inspection and expediting services and for providing training and facilities.

1For this approach see "UNIDO model form of turnkey lump-sum contract for the construction of a fertilizer plant" (UNIDO/PC. 25), art. 20.

12See chapter on "Scope and quality of works".

13Under the "UNIDO model form of cost-reimbursable contract for the construction of a fertilizer plant" (UNIDO/PC. 26), art. 20, a fixed price is to be stipulated for licences and know-how, procurement, inspection and expediting services and for providing training and facilities.
contracts or fee contracts. In a cost-reimbursable contract, the price is not a fixed amount, but rather the actual cost of executing the contract incurred by the contractor. The contractor is obliged to perform his obligation efficiently and economically, but subject to these conditions he is entitled to be paid whatever the execution of the contract costs him. In addition he is entitled to claim an additional payment (usually denominated as “fee”) to cover his overheads and to bring him a profit. The fee may be agreed upon in the form of a fixed amount, but it is sometimes determined as a percentage of the costs incurred in performing the contract (the so called “cost-plus-percentage-cost-contract”).

61. The main disadvantages of a cost-reimbursement pricing method are that the incentives to economy or speed of construction are greatly reduced. While the contractor is obliged to work efficiently and economically and not to waste resources or expenditure, in practice it is difficult to enforce this obligation. Furthermore, the contract must be carefully drafted to define what costs are reimbursable and what the payment arrangements are for subcontractors or suppliers. In addition, if the purchaser is to be properly protected, a cost-reimbursable contract requires detailed day-to-day supervision in checking the contractor’s claims for payment, and supervisory services may be expensive. Cost-reimbursable contracts are therefore advisable only for purchasers who have some experience in the industry involved and who can check the appropriateness of the contractor’s price claims at a reasonable cost.

62. Cost-reimbursable contracts may sometimes be used when the extent of work needed for the construction of the works cannot be accurately determined in advance, or where the major part of the construction is to be done by subcontractors and their charges are unknown at the time of conclusion of the contract. Since the total amount of the cost of the works is not determined at the conclusion of the contract, the purchaser will have to exercise control over expenditures during construction.

63. The uncertainty of the purchaser as to the total amount payable inherent in the reimbursable price method may be mitigated by the parties agreeing on an estimated cost. However, the effect of such an estimate should be clearly specified. The contractor might guarantee the estimate in which case he may be precluded under the contract from claiming any higher price. Alternatively, he may be entitled to claim only a percentage of the excess over the estimated cost. Where such limitations are imposed an increment is usually included in fixing the fee to be paid to him in order to cover the risks connected with the increase in costs.

64. The purchaser may find it advantageous to agree upon a method of determining the fee which gives an incentive to the contractor to reduce construction costs. In some works contracts (often called “incentive contracts”) a target cost of construction is fixed, and the contractor shares in any saving below such cost. On the other hand, it is not advisable to determine the fee by a percentage of the costs incurred by the contractor performing the contract, since he may be interested in increasing the cost of construction in order to obtain a higher fee. Since under a cost-reimbursable contract the purchaser pays the actual costs incurred by the contractor for the equipment, materials and services used in the construction, the purchaser usually has the right to select or approve suppliers or subcontractors. It is therefore possible for him to choose the optimum design and specifications for equipment and materials, and subcontractors offering the most competitive prices.

(c) Unit-price contracts

65. Under unit-price contracts (also called “remeasurement contracts”), the work to be done shown in the drawings and specifications is divided into recognizable work processes, capable of being individually priced. A unit price is then fixed for each work process (for example, per cubic meter of dredging, per cubic meter of reinforced concrete, per hour of work of electrical technician). It would be possible to make an estimate of the quantities of work to be done on the basis of the drawings and specifications, and, accordingly, on the basis of the rates quoted for the various units, an approximate price for the construction can be determined. However, a price for the construction as a whole is not specified in the contract, and the final price payable is dependent on the final measurement of quantities of work done or materials used in the construction and the number of hours spent by the contractor’s personnel in constructing the works.

66. This type of contract is advisable if the quantities of work to be done or materials to be used cannot be determined accurately in advance (for example, the quantities of work requiring removal when the foundations are excavated cannot be determined in advance). The risks connected with pricing are divided between the contractor and the purchaser. Since the price per work unit is firm the contractor bears the risk of increases in costs of materials and labour. The purchaser assumes the risk of an increase of price due to an increase in quantities of work or materials or amount of labour needed for the completion of the works over the estimate at the time of concluding the contract.

67. When entering into a unit-price contract, therefore, a purchaser should ensure that his estimate of quantities of work to be done is reasonably accurate, as otherwise he may be faced with a high degree of uncertainty as to the price payable. Furthermore, as the price payable depends on measurement of units of work done, parties should agree on clear rules as to how particular units are to be measured, or quantities ascertained. The purchaser will also incur some expenses in employing professionals to check the quantities of work done and their measurement.

68. While in a lump-sum contract a contractor will need to include a contingent element in the price to cover possible underestimates of the work to be done or the quantities of material needed, the unit-price method may eliminate this need. Accordingly, the price for the same quantity of work or material may be less in a unit-price contract than in a lump-sum contract. A unit-price contract will also be advantageous to a purchaser if there is a real possibility that the work to be done will turn out to be less than the estimated quantity of work.

69. In addition to the factors relating to design, co-ordination, allocation of responsibilities and price, the purchaser may also wish to consider the following factors.

C. Other factors to be taken into account in choosing contract type

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10See chapter “Price”.
11Ibid.
12See UNIDO, “Features and issues ...”, para. 30.
13Contract clauses are, however, sometimes used under which the price per work unit may be varied if the quantities of work done differ significantly upon final measurement from the estimated quantities of work.
1. Taxation

70. Parties should take into account the impact of tax liability on different types of contracts. Under some tax legislations the profit relating to a turnkey contract may be taxed at a higher rate than in the case of separate contracts. Under other legislations a turnkey contract may be considered as a sale of works, and the turnkey price taxed accordingly.²⁹

2. Selection of subcontractors

71. The purchaser may wish to select or to at least have an influence on the selection of subcontractors employed for the works construction. In developing countries it may be advisable to employ local enterprises in order to develop their technological capabilities and to conserve foreign exchange. However, a turnkey contractor may insist on choosing his own subcontractors since this contractor will be responsible for the subcontractors. A contractor under a lump-sum contract may also insist on selecting subcontractors in order to be able to control the cost of subcontracting so that he can make a profit within the fixed amount agreed upon in the contract.

3. Transfer of technology

72. In developing countries, works contracts are frequently intended to be a means of acquiring not only the physical works themselves but also technology. This transfer of technology always includes a transfer of information needed to use and operate the works. However, it often has a wider scope, covering technical and other knowledge, training and rights relating to patents, trademarks, design, copyrights and know-how. The scope of transfer of technology may depend on detailed contractual terms agreed upon by the parties, but can also be influenced by the contract type chosen by the parties. The minimum extent of the transfer of technology is mainly dependent upon the degree of the contractor’s responsibility to ensure the operation of the works; the transfer of technology is broader in a turnkey contract than in a semi-turnkey contract, and it is most limited under separate contracting. On the other hand, under separate contracting, in participating in the construction the purchaser’s personnel may acquire some experience and skill, in particular at handling the equipment.

73. There may be other aspects to be taken into consideration in selecting the contract type, such as the degree of the technical complexity of the construction processes to be used, the size of the works, performance specifications, the need for flexibility in changing the scope of the works (see paragraph 24, above), and requirements of a bank or organization financing construction.

D. Combination of contract types

74. In works contracts a combination of pricing methods for various suppliers is frequently used. In such cases the contract is denominated in accordance with the pricing method which is dominant. On the other hand, it is very difficult to combine the various contract types characterized by the allocation of parties’ responsibilities.

75. The parties may theoretically agree on various pricing methods in any type of contract characterized by the allocation of responsibility.³⁰ In practice, however, the turnkey contract is usually combined with a lump-sum price.³¹

²⁹ See chapter on “Costs of duties and taxes”.
³⁰ See UNIDO, “Features and issues ...”, paras. 29-31.
³¹ See “UNIDO model form of turnkey lump-sum contract ...”.

of the cost reimbursable pricing method may cause some difficulties in the types of contracts in which the contractor is responsible for achieving an agreed production capacity of the works, particularly in the turnkey contract. The application of the cost reimbursable method of pricing presupposes basically the purchaser’s right to approve the subcontractors chosen by the contractor or at least to approve the prices required by such subcontractors, thus permitting the purchaser to select them indirectly. However, the contractor may hesitate to assume total responsibility for the production capacity of the works without having the right to select his subcontractors. The unit-price method cannot be adopted as the main pricing method in a turnkey contract for a number of reasons. The nature of the work to be done does not lend itself to division into well recognized pricing units of a repetetive character. Furthermore, in regard to highly specialized manufacturing processes used in the contractor’s own factories which will often be a major part of the project, it will be very difficult for the purchaser’s personnel to verify or fix costs. The latter difficulty may also arise if the cost reimbursable pricing method applies.

76. What has been said in the previous paragraph in respect of the turnkey contract equally applies to the semi-turnkey contract. Under the separate contracts approach any pricing method can be used, although in particular circumstances one method may be more advantageous than others.³²

³² See chapter on “Price”.

[A/CN.9/WG.V/WP.9/Add.3]³³

CHAPTER XXXII. EXEMPTIONS:

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³³ April 1983. Referred to in Report, para. 90 (part one, A).
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A. General remarks

1. Impediments may occur which prevent the performance by a party of his contractual obligations. These impediments may be of a physical nature such as a natural disaster, or they may be of a legal nature (for example, after the conclusion of the contract the law on environment protection in the purchaser's country is amended to prevent the use of the equipment specified in the contract). The impediments may prevent performance permanently or for a limited period, or they may prevent performance on time.

2. This chapter deals with the question of what impediments can exempt a party from liability to compensate the other party for loss suffered by the failure to perform an obligation. Other issues which parties should deal with are considered in other chapters. For instance, a change which may be required in the scope of construction together with a consequent change in the price, is dealt with in the chapter “Changes in scope and quality of works”. Modifications which may be required of other contractual terms are dealt with in the chapter “Variation”. The issue of who is to pay the costs incurred in a reconstruction of plant damaged as a result of such impediments is dealt with in the chapter “Passing of risks”. The effects of exemptions on a penalty or liquidated damages clause are discussed in the chapter “Liquidated damages and penalty clauses”. The chapter “Suspension” discusses the situations when an exempting impediment causing a delay justifies the suspension of a contract and the legal effects of such suspension. If the impediments are permanent or of a long-term nature and cannot be overcome by a modification of the scope of the contract or variation of its terms, it may become necessary to terminate the contract. This issue is discussed in the chapter “Termination of contract”.

3. The grounds for exemption should be settled by the parties after taking into account the nature of a works contract. Performance of a works contract extends over a long period of time, and the contract is generally of a comprehensive and complex nature. Accordingly, clauses intended to be applied to various types of contracts may not always be appropriate. Parties may in addition wish to note that giving a wide scope to an exemption clause creates uncertainty as to the obligations imposed under the contract, as parties are excused from performance in a wide range of circumstances. Furthermore, the effect of the operation of an exemption is to place the loss caused by the exempted failure of performance on the party not invoking the exemption, thereby creating an exception to the normal rule that a party who fails to perform must bear the loss caused by such failure. Considering the heavy losses which may be caused by a failure of performance in a works contract, it may be desirable to limit the scope of the exemption clause. Additionally, a narrow scope of exemption may encourage careful planning by the parties to avoid failures of performance which may be costly to both of them. It is recommended that, as a minimum, a party should only be exempted if an impediment is of a physical or legal nature that prevents the performance by him of an obligation, and that such party could not by reasonable efforts overcome or avoid the impediment or its consequences. However, circumstances which only make the performance more onerous or cause economic hardship, should not be treated as exempting.\(^2\) The scope of exemption has, however, ultimately to be determined in the light of the special circumstances attending the contract in question, and such circumstances may require a narrower or wider scope of exemption than that indicated above. Because of the nature of the performances to be executed by the parties it is evident that in most cases exempting impediments would prevent performance by the contractor. A wide definition of exempting impediments may therefore increase the purchaser's risk of loss.

4. Both parties should be able to invoke the exemption clause as in some situations the purchaser may also need to be exempt from failure to perform some of his obligations (for example, to provide the site in time or to supply water or power needed for construction).

B. Exemption clause and applicable law

5. The parties may find it advisable to include in their contract clauses which define the conditions under which the parties are exempt from liability to pay damages for loss caused by either party's failure to perform his obligation. Alternatively, they may wish to leave the issue of liability for damages to be settled under the rules of the applicable law. However, institutions financing the construction of industrial works frequently insist on such a clause in the contract as it is of great importance for determining the risks connected with financing the construction.

6. If parties do wish to refer the issue of exemptions solely to the applicable law, it would be advisable to provide expressly for this in their contract. In deciding whether the settlement of the issue by the applicable law is preferable, parties should examine the relevant rules of that law to determine whether they are appropriate to settle the special problems that may arise when performance of a works contract is prevented, or whether the rules need to be supplemented or modified by exemption clauses in the contract.

7. Where parties desire both the rules of the applicable law and the exemption clauses in the contract to regulate the issue of exemptions, the contract should clearly so provide. In most cases, however, it is not advisable to permit the contract to be regulated both by exempting impediments on the basis of the applicable law and also by the exemption clauses, as the combination of the two approaches to a situation may be inconsistent and may unduly widen the scope of exemptions.

8. At the same time, where parties wish to settle the issue of exemptions by express provisions in their contract, they should carefully consider the extent to which the mandatory rules of the applicable law would limit their power to do so. In drafting an exemption clause, parties may use the terminology of the applicable law, provided that they do not intend to modify the meaning given to that terminology under that law. Otherwise, terminology (such as force majeure, frustration, fault or recklessness) which may have a special meaning in some legal systems should be avoided.

C. Methods of drafting

9. In drafting an exemption provision, parties may adopt one of the following approaches:

   (i) Providing a general definition of exempting impediments;

\(^2\) See chapter "Hardship clauses".
Combining a general definition with a list of impediments;

Providing a list of exempting impediments. The list may be exhaustive or non-exhaustive.

and may also wish to consider the following issues:

Exclusion of certain impediments from the scope of exemption;

The scope of exemption when failure of performance is caused by a third person employed by a party.

1. General definition of exempting impediments

10. Parties frequently include in the contract a definition qualifying the impediments in general terms. Such a definition avoids the danger of overlooking some impediments which parties might have considered as exempting (see paragraph 24, below) and problems of interpretation resulting from the mere listing of exempting impediments without the necessary criteria determining when the impediments are exempting (see paragraphs 22-29, below). On the other hand such a general definition, if not followed by an illustrative list (see paragraph 18, below), may sometimes give rise to difficulties in determining whether or not a particular impediment is covered by the definition. Parties should consider the inclusion of the following elements in a general definition.

(a) That the physical or legal impediment must unavoidably prevent performance

11. This element embraces two interrelated requirements. As a first requirement, parties may wish to stipulate that the physical or legal impediment must, permanently or temporarily, prevent performance of an obligation, and not, for instance, only make performance inconvenient or more expensive. As a second requirement parties may wish to stipulate that an impediment would exempt a party only if it were beyond his control. In addition, to determine whether performance is prevented by an impediment it will be relevant to consider what measures might have been taken to overcome or avoid the impediment or its consequences. Therefore the exemption clause should stipulate the standard of conduct a party would be expected to observe for this purpose. As regards the standard to be expected, it would unduly restrict the scope of the exemption to require that a party is exempt only if he proves that the impediment or its consequences could not have been overcome or avoided by the taking of every conceivable measure. On the other hand, not to require the party to take measures to overcome or avoid it or its consequences, may encourage a party to seek to rely on impediments to evade performance of his obligations. However, it would not be advisable to require a party to take measures which promise only a very slight chance of success with a high degree of risk (for example, to run a military blockade). Accordingly, it may be advisable to stipulate that a party is exempted only if he proves that a physical or legal impediment or its consequences prevented his performance and that he could not reasonably have been expected to overcome or avoid it or its consequences.3

12. It may not be desirable to stipulate that the impediment could not have been reasonably avoided by both parties. The party invoking an impediment should be exempted even if the impediment could be averted by the other party.

13. It is suggested that inclusion of this requirement (i.e. that the impediment must unavoidably prevent performance) is necessary if a general definition is to be acceptable. However, parties may also wish to consider the additional elements set out below.

(b) That the impediment was unforeseeable

14. Parties may wish to provide as a necessary condition for the exemption of a party that he could not reasonably foresee an impediment at the time of the conclusion of the contract. A party may, however, foresee an impediment but not its effects on the performance of his obligation. Parties may therefore wish to provide that a party is exempted if he could not reasonably be expected to take into account at the time of the conclusion of the contract the effect of an impediment upon his ability to perform.

(c) That the impediments must intervene after conclusion of the contract

15. Parties may wish to provide as part of the condition for the exemption of a party that the impediments cannot reasonably foresee an impediment at the time of the conclusion of the contract and the consequences of these impediments. This approach may be justified on the ground that impediments occurring at the time of the conclusion of a contract should be known to a party and taken into account by him when entering into a contract. This element may be combined with element (a) noted above (i.e. a party is exempted if impediments beyond his control intervening after the conclusion of the contract unavoidably prevent performance) or with elements (a) and (b) (i.e. a party is exempted if impediments intervene after the conclusion of the contract and are unavoidable and unforeseeable).

(d) That the impediment must be of an extraordinary nature

16. Parties may wish to stipulate that the impediments must be of an extraordinary nature if they are to be exempting. If they so stipulate, impediments which normally occur (for example, the normal freezing of rivers in winter) would not exempt. This element may be combined with element (a) or element (c) noted above. Since in most cases an extraordinary impediment will not be reasonably foreseeable, it is usually used only as a substitute for, but not in combination with, element (b) noted above. However, there may be some cases where an impediment could not reasonably be foreseen at the time of the conclusion of the contract by a party in the same position as the failing party, but where the impediment could not be considered as extraordinary. Accordingly, the inclusion of the element that the impediment must be of an extraordinary nature may narrow the scope of the exemption.

2. Definition followed by a list of exempting impediments

17. A general definition of exempting impediments followed by a list of exempting impediments could combine flexibility with certainty. The following approaches may be considered by the parties.

(a) Definition followed by an illustrative list

18. Under this approach, a general definition is followed by a list of impediments which, if they satisfy the conditions in

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3This approach is based to some extent on article 79 (1) of the United Nations Convention on Contracts for the International Sale of Goods (A/CONF. 89/13, annex I) (Yearbook ... 1978, part three, I, B) which reads as follows:

"(1) A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences."

12. It may not be desirable to stipulate that the impediment could not have been reasonably avoided by both parties. The party invoking an impediment should be exempted even if the impediment could be averted by the other party.

13. It is suggested that inclusion of this requirement (i.e. that the impediment must unavoidably prevent performance) is necessary if a general definition is to be acceptable. However, parties may also wish to consider the additional elements set out below.

(b) That the impediment was unforeseeable

14. Parties may wish to provide as a necessary condition for the exemption of a party that he could not reasonably foresee an impediment at the time of the conclusion of the contract. A party may, however, foresee an impediment but not its effects on the performance of his obligation. Parties may therefore wish to provide that a party is exempted if he could not reasonably be expected to take into account at the time of the conclusion of the contract the effect of an impediment upon his ability to perform.

(c) That the impediments must intervene after conclusion of the contract

15. Parties may wish to provide as part of the condition for the exemption of a party that the impediments cannot reasonably foresee an impediment at the time of the conclusion of the contract and the consequences of these impediments. This approach may be justified on the ground that impediments occurring at the time of the conclusion of a contract should be known to a party and taken into account by him when entering into a contract. This element may be combined with element (a) noted above (i.e. a party is exempted if impediments beyond his control intervening after the conclusion of the contract unavoidably prevent performance) or with elements (a) and (b) (i.e. a party is exempted if impediments intervene after the conclusion of the contract and are unavoidable and unforeseeable).

(d) That the impediment must be of an extraordinary nature

16. Parties may wish to stipulate that the impediments must be of an extraordinary nature if they are to be exempting. If they so stipulate, impediments which normally occur (for example, the normal freezing of rivers in winter) would not exempt. This element may be combined with element (a) or element (c) noted above. Since in most cases an extraordinary impediment will not be reasonably foreseeable, it is usually used only as a substitute for, but not in combination with, element (b) noted above. However, there may be some cases where an impediment could not reasonably be foreseen at the time of the conclusion of the contract by a party in the same position as the failing party, but where the impediment could not be considered as extraordinary. Accordingly, the inclusion of the element that the impediment must be of an extraordinary nature may narrow the scope of the exemption.

2. Definition followed by a list of exempting impediments

17. A general definition of exempting impediments followed by a list of exempting impediments could combine flexibility with certainty. The following approaches may be considered by the parties.

(a) Definition followed by an illustrative list

18. Under this approach, a general definition is followed by a list of impediments which, if they satisfy the conditions in
the general definition, would have an exemptive effect. Care should be taken to indicate that the list of impediments is not exhaustive. Parties should include in the list impediments which they clearly desire should have an exemptive effect, but which might possibly be regarded as falling outside the general definition. The examples might also be chosen so as to clarify the scope of the general definition.

(b) Definition followed by an exhaustive list

19. Parties may prefer an exemption clause in which the list of impediments, however wide or narrow, is exhaustive. The listed impediments must satisfy the elements set out in the general definition to have an exemptive effect. Under this approach, impediments which are not in the list, even though they may fall within the scope of the general definition, do not exempt. Accordingly, parties should use this approach only if they are certain that they can foresee and list all the impediments which they wish to be exempting.

(c) Definition followed by an additional list of exempting impediments outside the scope of the definition

20. Under this approach, parties may lay down a general definition of exempting impediments, and in addition include a list of specific impediments which are exempting whether or not they fall within the definition given. For example, the definition may include the element of unforeseeability, but the specific impediments in the list would be exempting, whether they were foreseeable or not. As these impediments have an independent exempting effect, the observations made in paragraph 22 would equally apply here.

21. This approach may be useful where parties have chosen a narrow general definition but may wish, nonetheless, that certain impediments which do not fall within the scope of the definition that they have adopted should be exempting.

3. List of impediments: non-exhaustive or exhaustive

22. Some exemption clauses in practice simply provide a list of impediments either non-exhaustive or exhaustive, without any general definition. These clauses often do not provide any set of criteria to determine when the impediments are exempting, which is unsatisfactory. If, however, the parties do not wish to have a general definition but only a list of exempting impediments, they must decide whether the list is to be non-exhaustive or exhaustive. In preparing the list (whether non-exhaustive or exhaustive) care should be taken to set out the criteria and qualifications under which a particular impediment would be considered exempting, since there is no general definition which can be resorted to. It is not sufficient simply to include "war" or "military activity" within a particular list parties should go further and state that the war or military activity is such as prevents the performance of the obligations (see paragraph 27, below). As another example, the mere mention of "explosions" as an exempting impediment would raise questions such as whether an explosion would exempt a party even if it were caused by the negligence of that party, and what effect the explosion must have on the performance due from that party before it would have an exempting effect.

23. A non-exhaustive list is intended to provide some examples of exempting impediments. If the parties have agreed that the issue of exemption would not be governed by the applicable law, there may be difficulty in determining what impediments other than those listed are exempting. The list itself may provide no guidance as to what impediments other than those listed the parties intended to be exempting. If, in addition to the list the applicable law regulates the issue of exemptions, that law will determine what impediments other than those listed will exempt.

24. An exhaustive list of impediments may be unsatisfactory because parties may overlook certain impediments which they intend to have an exemptive effect. As the list is exhaustive, the applicable law, except its mandatory rules, is excluded and cannot remedy such an oversight.

25. Natural disasters (such as earthquakes, floods, cyclones, sandstorms) are often listed as exempting impediments. If the parties decide to include such impediments in the list, the contract should provide that the party failing to perform is exempted only to the extent to which and during the time when the consequences of such a natural disaster prevent him from performing, and only if such consequences thereof cannot be avoided or overcome. Storms, cyclones, floods or sandstorms may in fact be the normal weather conditions at a particular time of the year at the place where the construction is carried out and should be taken into consideration by the contractor in agreeing to a time-schedule for the construction and they should not exempt the contractor if their consequences can be avoided or overcome by him.

26. Unexpected site conditions may render the contract physically impossible of performance in accordance with the contract. They may arise from latent physical conditions differing materially from those indicated in the contract, in the feasibility study or from those ordinarily encountered. The contractor should not be exempted if such conditions could have been discovered or foreseen by him and if he was obliged to do so. If the contractor assumes all risks relating to site conditions he should not be exempt even if unexpected site conditions could not have been discovered or foreseen.

27. War (whether declared or not) or other military activity is usually considered to be an exempting impediment. One difficulty is to determine when a war or a particular military activity can be considered as preventing performance of an obligation and therefore exempting a party. For instance, frequent air-raids near the construction site may create a high risk to the safety of the contractor's employees without preventing them directly from continuing the construction. Parties may therefore wish to specify very clearly when a war or other military activity is considered to prevent performance.

28. Strikes, boycotts, go-slows and occupation of factories or premises by workers should not be considered as exempting impediments if they are caused by the personnel of the contractor, as the liability of a party to perform should not be reduced because of the conduct of his own employees. In addition it may be difficult to determine whether strikes by the contractor's personnel and other labour disputes are avoidable or not. A strike by the purchaser's personnel may be regarded as an exempting impediment for the contractor, if the employment of such personnel is required under the contract for the execution of the performance by the contractor (for example, for supervision of erection).

29. Shortages of raw materials needed for the construction should not usually be considered as an exempting impediment. The contractor should be obliged to procure such materials in time and he should be responsible if he fails to do so. If his supplier fails to supply such materials to the contractor in time, the contractor can normally claim damages.
4. Exclusion of impediments

30. Whichever approach is adopted, parties may wish further to clarify the scope of an exemption clause by expressly excluding some impediments which might otherwise conceivably come within the scope of such a clause, for example, the financial position of a party which prevents him from performing. Parties may also wish to consider excluding impediments which occur after a breach of contract by a party and which, but for the breach, would not have prevented performance by that party.

31. The exemption clause should, in principle, include as exempting impediments any legal impediments which prevent performance of an obligation (for example, any new legislation preventing performance).

32. Parties may however wish to exclude certain acts of State organs from being regarded as exempting impediments. A contract usually imposes an obligation on a party to secure a licence or other official approval which may be required in his country for the performance of certain of his obligations. If such a licence or approval is refused by a State organ, or if it is later withdrawn, parties may wish to agree that the party who does not secure or loses the licence or approval cannot rely on the act of the State organ as an exempting impediment in respect of the failure to perform resulting from the absence of the licence or approval. If parties do not so agree, a party who does not wish to proceed with the contract might be tempted not to take all necessary measures to obtain the needed licence or approval. It may be extremely difficult for the other party to determine whether the measures taken to obtain the licence or approval are adequate. Parties may also consider that it is fairer that the loss caused by the failure to perform resulting from the absence of the licence or approval should be borne by the party who had the duty to secure it.

33. Parties may also wish to consider the position where, apart from the refusal or withdrawal of a licence or approval, the performance of a party is prohibited by an act of a State organ (for example, prohibiting the export of a certain kind of technology). Enforcement of the performance prohibited by a legal system would usually be contrary to the public policy under such legal system and the performance prohibited in the country of the party who is to perform may be considered as legally impossible, even if another legal system is to apply to the contract. Under some legal systems, however, parties may be permitted to include in the contract a provision under which a party whose performance is prohibited should compensate the other party for the loss caused by the failure of performance due to such prohibition.

5. Failure caused by third person

34. It is common in a works contract for a party to employ third persons (e.g. subcontractors) to perform his obligations under the contract. Where the party fails to perform due to the failure by a third person whom the party has engaged to perform the whole part of the contract, the question arises whether and to what extent the party is exempt from liability.

35. In addressing this question, parties may wish to note that in general the liability of a party for failure of performance should not be reduced because he employs third persons to execute performance. Parties may therefore find it advisable to provide only a limited exemption to a party who seeks to excuse himself on the ground that his failure was caused by a failure by such third persons. A possible approach may be to provide that a party is exempted in such circumstances only if two conditions are satisfied: firstly, that the party is exempted under the exemption clause in the construction contract; and secondly, that the third person would be exempted if the exemption clause in the works contract were contained in the contract between the party and the third person. The extent of liability of the contractor for a performance of a subcontractor may, however, depend upon whether the subcontractor has been chosen by the contractor or the purchaser.

36. An alternative approach would be to exempt the contractor employing a third person if he proves that he took reasonable care in selecting the third person. However, this approach may give insufficient protection to the purchaser. The contractor employing the third person would in this case have little incentive to continue to supervise the third person after the latter is selected, or to pursue remedies against him for his failure of performance. Furthermore, by exercising care at the moment of selection, the selecting party can effectively divest himself of the responsibilities for performance which he had assumed.

37. It has been suggested that, where performance by a party has been prevented by an impediment, the party should only be exempted if by taking reasonable measures he could not have overcome or avoided the impediment or its consequences. Accordingly, when a third person employed by a party fails to perform, the party should seek to overcome the impediment by employing another person. When, however, a subcontractor is designated in the contract by agreement of the parties, or is chosen by the purchaser, the contractor cannot employ another subcontractor without a variation of the contract or a new approval by the purchaser, or a choice of another subcontractor by the purchaser. In such cases the contractor may be exempted upon his proving that the subcontractor’s failure to perform resulted from an exempting impedance as defined in the contract between the parties. Parties may wish to specify the steps which a contractor should take when a third person fails to perform in these special cases (for example, that the contractor should propose to the purchaser the name of another person who may be employed).

D. Notification of impediments

1. Notification to notify

38. A party who invokes an impediment should be obligated under the contract to notify the other party of the impediment which prevented or is likely to prevent the performance of any of his obligations, and of the cessation of the impediment. This notification may facilitate the taking of measures by the other party to mitigate the loss caused or which is likely to be caused by the failure of performance.

39. The parties should consider the form, means of communication and contents of the notice, and the period of
time within which it should be given. The form of the notice may depend on the circumstances in question. Generally, notice in writing should be required. The means of communication may be cable or telex (when such means of communication are available), confirmed by registered airmail. Parties should also specify when a notification takes effect (for example, at the time of despatch, or receipt).

40. The notice should specify details concerning the impediment together with evidence that the performance is thereby prevented, and if possible the anticipated period of its duration. The party invoking the exemption may also be required to continue to keep the other party informed of all circumstances which may be relevant for an appraisal of the impediment and its effects.

41. As exemptions have serious consequences on the legal position of the parties, verification of the events relied on as exempting impediments may be required when feasible (for example, by a public authority, notary public, a consultate or chamber of commerce in the country where the impediment occurred). Parties should consider the evidentiary effect to be given to such verification.

42. The parties may require the notice to be given immediately, or without undue delay, or within a time-limit agreed to in the contract, after the party invoking the exemptions learned or could be reasonably expected to learn of the occurrence or likelihood of the occurrence of the impediment. When a party knows in advance that an impediment will occur, he should not be permitted to postpone the notification until the date when the obligation is to be performed, as the prevention or the mitigation by the other party of the loss which will be caused by the failure to perform requires the information to be given as soon as possible. If the parties require that the notification is to be given immediately or within an agreed time-limit, they should also take into consideration the fact that such notification may sometimes be impossible (for example, in case of natural disasters) and should therefore enable an adequate extension of time in these cases.

43. The party invoking an exemption should also be required to notify the other party, within an agreed time-limit, of the cessation of the impediment or its effects. This period should start running after the notifying party has learned or could reasonably be expected to learn of the cessation of the impediment or its effects.

44. The parties may further wish to provide that, upon notification of the exempting impediments, they should deliberate on what measures to take in order to prevent or limit the effects of impediments, and to prevent or mitigate any damage which may be caused by them. A modification of the scope of construction or the specification of equipment or a variation of some contractual terms may be needed. 8

2. Legal effects of failure to notify

45. Express provision should be made for the consequences of failure to notify the other party of an exempting impediment. Even if parties decide that no legal effects should flow from the failure to notify, this should be expressly stated. However, such instances should be limited to cases where there is no probability of loss being caused by such failure.

46. In some cases the parties may consider a timely notification of the impediments to be so important that the party failing to notify in time should thereby lose his right to invoke the exemption. If this legal effect is intended, it should be clearly provided for in the contract. In most cases, however, the failure to notify in time should not entail loss of the right to rely on the exemption.

47. The parties may wish to provide that a party can rely on an impediment from the time it occurred even if he has failed to notify in time, but that in such a case he is liable to compensate the other party for damage resulting from the delay in notification.

48. A compromise approach may be to combine the effects mentioned in paragraphs 47 and 48. Parties may provide that an exemption is effective from the time the impediment occurs only if notice is given in time. If the party fails to notify in time, the exemption would become effective only from the time of notification. The party failing to notify in time is liable to compensate for damage resulting from the delay in notification.

E. Legal effects of exemptions

49. The main legal effect of an exemption clause should be to relieve the party, whose performance is prevented by the exempting impediment, from liability to pay damages for loss caused by the failure to perform. 9 If an impediment prevents performance by a party of only part of an obligation, the exemption should apply only in respect of that part. If an impediment prevents a party from performing his obligation only temporarily, the exemption should be effective only for the period during which performance is prevented by an exempting impediment or its consequences. For example, if a flood prevents construction, the exemption should be effective only for the duration of the flood if construction can recommence immediately after the flood subsides. If, however, construction cannot recommence until the consequences of the flood are remedied, the exemption should continue until the remedy is completed (for instance, until the mud and stones are removed).

50. The other possible legal effects, which have been noted in paragraph 2 above, should also be considered by the parties. Other rights and remedies may or may not be affected by the exempting impediments. For example, while the failing party may be relieved from damages, he may still be liable for penalties or liquidated damages under a penalty or liquidated damages clause. If the parties wish to exempt the party invoking an exempting impediment from other remedies, they should expressly so provide in the respective contract clauses relating to such remedies.

8See chapter "Changes in scope and quality of works" and chapter "Variation".

9This approach is based on article 79 (4) of the United Nations Convention on Contracts for the International Sale of Goods, which reads:

"(4) The party who fails to perform must give notice to the other party of the impediment and its effect on his ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, he is liable for damages resulting from such non-receipt."

9This effect is stipulated in article 79 (5) of the United Nations Convention on Contracts for the International Sale of Goods, which reads:

"(5) Nothing in this article prevents either party from exercising any right other than to claim damages under this Convention."
CHAPTER XXXIV. HARDSHIP CLAUSES

A. General remarks

1. “Hardship” is not a legal concept; it has been employed in some clauses in international contracts to describe situations where economic, financial, legal, political or technological factors have changed causing serious economic consequences to a party in a contract. Most hardship clauses provide for the renegotiation of contracts in order to adapt them to new situations. However, some hardship clauses in practice provide for termination without first resorting to renegotiation. This should, however, be discouraged.

2. Attention is directed to two main aspects of a typical hardship clause: first, what constitutes hardship and, secondly, the adaptation of the contract to the new situation through the mechanism of renegotiation. The legal effect of a hardship clause may differ under different legal systems. Also, the adaptation of a contract, due to changed circumstances, may be recognized under some legal systems and not in others (see paragraphs 36-38, below). Parties contemplating a hardship clause should consider whether the applicable law makes provision for changed circumstances affecting the economics of the contract. If it does, the parties may wish to consider whether it is suitable or adequate for their purpose. If the applicable law is not suitable or adequate, but is mandatory, parties may wish to choose another applicable law. If the applicable law is not mandatory parties may modify it (see paragraph 6, below).

3. The Guide draws a distinction between hardship clauses and exemption clauses in that in a hardship situation the contract is not incapable of performance whereas an exempting impediment must render a contract incapable of performance, whether temporarily or permanently.1

4. Hardship clauses should be distinguished from other similar clauses (e.g. index clauses) which deal with situations concerning the economics of the contract. Such clauses, for example those dealing with currency fluctuations, are usually well-defined as the changed circumstances are predictable and hence the precise consequences can be provided for; no renegotiations are needed unlike in a hardship clause (see paragraph 9, below). Thus, for example, a predetermined formula may apply automatically in the event of a currency fluctuation to realign the contract to changed circumstances.

B. Factors to be considered as to whether to include a hardship clause

5. Although the advantages and disadvantages of a hardship clause will depend on the way it is drafted (e.g. a widely formulated hardship clause will have adverse effects on the stability of the contract and will tend to lean in favour of the contractor), nonetheless, certain advantages and disadvantages may be discerned.

6. Advantages of a hardship clause:

(a) Some legal systems may recognize the adaptation of contracts in the event of changed circumstances disrupting the initial equilibrium of the parties. However, the law may be too flexible or too restrictive (e.g. leading only to termination, or only permitting adaptation of contracts by courts). In such situations, a hardship clause can be usefully drafted to modify the applicable law, if it is not mandatory (see paragraph 2, above);

(b) Since industrial works contracts are of a long-term nature and cannot be easily terminated, renegotiation of such contracts to adapt them to new situations may be acceptable;

(c) In the absence of a hardship clause, a party, say, the contractor may decide to terminate the contract even though he would be liable for breach, provided the legal system permits. Under some legal systems, however, the party may not be able to terminate the contract. Where a hardship clause exists the contract may be saved through renegotiations, perhaps to the ultimate benefit of both parties. Although there is nothing to prevent parties from renegotiating in the absence of a renegotiation clause, nonetheless, an express provision for renegotiations can take into consideration certain factors to ensure greater predictability and a fair determination of the outcome (see paragraphs 28-33, below). The rights and obligations of the parties during renegotiations can also be regulated (see paragraphs 46-47, below).

7. Despite the above-mentioned advantages there are serious disadvantages which may outweigh the advantages:

(a) A hardship clause with the mechanism for readaptation renders the contract uncertain and unstable;

(b) However carefully drafted, a general hardship clause could prove imprecise and vague because of the nature of hardship itself. Moreover, hardship clauses are of recent origin and their validity has seldom, if ever, been tested in the courts or the arbitral tribunals in some legal systems;

(c) The mechanism for renegotiation may protract the time for the performance of obligations under the contract;

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1 See chapter “Exemptions”.

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*22 March 1983. Referred to in Report, para. 90 (part one, A).*
8. In determining the question whether or not to have a hardship clause parties should, apart from considering the advantages or disadvantages, also consider which party is more likely to invoke such a clause, and the impact it might have on the performance of the contract (see paragraph 7, above). Hardship clauses generally tend to favour the contractor more than the purchaser, for he has more reason to invoke a hardship situation as when he finds that the costs of executing the contract are higher than he anticipated. Moreover, hardship clauses may tend to encourage contractors to offer a low price in order to secure the contract, if they think that they might subsequently be able to rely on a hardship clause to renegotiate the contract. In so far as the purchaser is concerned, his position is such that there will be fewer occasions when he would need to rely on a hardship clause. Changed circumstances affecting his position can generally be dealt with within the framework of the contract. 3

9. Instead of using a hardship clause, which does not deal with the exact consequences of a hardship situation but leaves the matter for renegotiations, it is better to have specific clauses (e.g. currency fluctuation or index clauses) to deal with particular situations affecting the economics of the contract and where well-defined formulae can be used for an automatic economic adjustment. However, a particular formula may turn out to be unworkable or certain specific clauses may not be recognized under a legal system. In such situations, a hardship clause could be useful.

C. Approach to drafting a hardship clause: general definition followed by exhaustive list

10. As a matter of policy, hardship clauses, if they are to be included in a contract, should be circumscribed and confined to exceptional circumstances. Also, in view of the doubtful legal effect of hardship clauses under some legal systems, extreme care should be taken in their drafting, if parties wish to insert such a clause in their contract. A hardship clause which simply sets out in general terms open-ended and vague criteria for its application (e.g. “changed circumstances”, “upsetting the initial equilibrium of the parties”, and “causing serious economic consequences”) should be avoided. Equally unsatisfactory is an approach which merely provides a list of hardship situations which is not intended to be exhaustive. Even if the general definition were to be accompanied by an illustrative list, the approach is still too flexible, and the scope may still be vague. 3

11. An approach which might be acceptable from a legal and policy viewpoint, is a general definition followed by an exhaustive list of hardship situations. Such an approach ensures that parties have to be specific and will know the scope of the hardship clause in advance. However, because of the nature of hardship, the clause may still turn out to be imprecise. Nevertheless, this approach has the advantages that, firstly, doubts as to what specific circumstances come under the general definition are avoided. Secondly, it reduces the uncertainties created by a mere list of situations which is not clear as to when such situations are to be regarded as hardship situations.

1. General definition

12. The scope of the general definition should be narrow and should at least include the following elements: change of circumstances, nature of change in circumstances (unforeseeable and beyond the control of the party invoking the hardship clause), and consequences of change in circumstances (serious economic consequences).

(a) Changed circumstances

13. The hardship clause should cover situations in which the circumstances which existed at the time the contract was concluded have undergone a change. Such a change in circumstances should not lead to an application of the clause unless it produces serious economic consequences. In some hardship clauses the change itself is qualified, that is, it is required to be “substantial”, “fundamental” or “serious”. It is suggested, however, that the seriousness of the consequences of the change, rather than that of the change itself, should be the focus of the definition of hardship circumstances (see paragraphs 19-21, below).

14. Instead of relying on a general formulation of a “change in circumstances”, the parties should delimit the change in circumstances more specifically by reference to particular areas in which a change of circumstances might be relevant for the particular contract concerned. For example, the clause should specify that the change must be due to economic, financial, legal, political or technological circumstances.

15. It is preferable to require that the change in circumstances must occur after the conclusion of the contract. The parties should be deemed to have taken into account circumstances which have occurred up to the time when the contract was concluded.

(b) Unavoidable, unforeseeable or extraordinary nature of the change

16. It is advisable to provide in all cases that a party may invoke the clause only if the change in circumstances was not caused by him. The contract may also require that the party could not reasonably have been expected to avoid the change or overcome its consequences. The considerations in this regard in connection with exempting impediments also apply here. 4

17. The scope of the hardship clause may be narrowed further by requiring the change in circumstances to be unforeseeable. If this requirement is adopted, it should be formulated in an objective manner so that it would not be sufficient for the party to show merely that he did not foresee the change; the change should not be reasonably foreseeable. 5

18. In some cases the requirement that the change in circumstances be unforeseeable may be replaced by a requirement that the change be extraordinary. This requirement is more objective than the “unforeseeable” requirement (even according to the formulation suggested in paragraph 17), since the “extraordinary” requirement takes even less account of the foresight of the party invoking the clause.

(c) Serious economic consequences

19. A change in the circumstances existing at the time the contract was concluded should not be enough to justify an application of the hardship clause. It should also be required that the change in circumstances must result in serious economic consequences for the party invoking the clause.

2See, for example, chapters on “Scope of contract” and “Termination” (termination for convenience).

3See chapter “Exemptions” where these various approaches are considered.

4See chapter “Exemptions”.

5Ibid.
20. It is advisable to quantify the consequences resulting from the change in circumstances so that the contract will not be subject to renegotiation upon the occurrence of economic effects which are within the risk that a party should bear. This may be done in a general way, by using a term such as "substantial financial burden". The use of such a term, however, could give rise to difficulties of interpretation and application in concrete situations. Similar difficulties could arise if the parties were to add to or substitute for such a term equally vague concepts of equity or fairness (e.g. "undue hardship" or "unfair prejudice"). If possible, the parties should attempt to quantify the seriousness of the consequences more concretely (for example, by requiring cost increases to exceed a specified amount or percentage of the price).

21. The parties should consider the degree of likelihood of serious economic consequences to a party as a result of the change in circumstances which should be required before a clause can be invoked. In some situations it might be sufficient to require that the party invoking the clause must establish that these consequences are very likely to occur, or even that the risk of their occurrence has substantially increased. In other situations it might be advisable to require the party to establish that the consequences will occur beyond any doubt.

2. The exhaustive list

22. Due to the very broad range of circumstances which may change after the conclusion of the contract the parties may wish to limit the scope of the application of the clause by having an exhaustive list of hardship situations.

23. Under the approach suggested (general definition followed by an exhaustive list), the list of hardship situations must also satisfy the criteria set out in the definition. Owing to the imprecise nature of hardship it is advisable to tighten the scope of a hardship clause further by including a list of situations to be excluded which might otherwise be included under the list read in conjunction with the general definition. The parties may, for example, exclude circumstances arising from a weakening of the financial position of a party or a change in the economic situation of the country. They may also exclude circumstances occurring after the party invoking the clause is in breach of the obligation in respect of which the hardship is claimed.

24. The application of the clause may also be restricted by preventing the clause from being invoked within a certain period of time after the conclusion of the contract. Furthermore, the parties may agree to restrict the number of times or the frequency with which a party may invoke the clause. Such provisions are aimed at reducing the element of uncertainty and instability which a hardship clause introduces into the contract.

D. Renegotiations

25. The parties may wish to decide whether the renegotiation provision should carry with it only an obligation to participate in the renegotiations, or whether it should go further by requiring an agreement as to the adaptation of the contract. The purpose of the former approach is only to give an opportunity to the party suggesting the renegotiations to put up his proposals, but the other party has the option whether or not to accept them. In such a situation parties may not wish to authorize a court, an arbitrator or a third party to modify the contract on their behalf. However, they may agree upon a third person who could assist them in an independent and impartial manner in their attempt to reach an agreement on a reasonable modification of the contract terms. In the event of a failure to reach any agreement the parties may intend that the contract is to continue according to its original terms. This should be clearly stated in the contract. Provided the parties participate in the renegotiations there is no obligation to reach an agreement. Hence, there is no breach if parties fail to reach an agreement.

26. The decision as to which obligation should be imposed upon the parties (i.e., participate in the renegotiations, or renegotiate and reach an agreement) will depend to some extent upon the consequences which the parties intend in the event that renegotiations are not successful. Three types of consequences are possible if the parties fail to agree upon an adaptation of the contract: continuation of the contract according to its original terms; adaptation of the contract by a court, an arbitrator or a third party; or termination of the contract. However, if it is provided that parties must come to some agreement, the party who is entitled to invoke the renegotiation clause should have the right to resort to a court, an arbitrator or a third party to adapt the contract on behalf of the parties in case no agreement is reached (see paragraphs 36-44, below). If the parties intend the contract to continue according to its original terms, then it will be sufficient to obligate the parties only to participate in the renegotiations. If they fail to reach an agreement, neither party will be in breach for the failure to agree, and the original contract can continue. On the other hand, if the parties intend the contract to be adapted by a court or an arbitrator or by a third party in the event of a failure to agree to an adaptation parties should make express provision to this effect (see paragraph 38, below).

27. Whichever obligation is imposed, the parties should be careful to co-ordinate this aspect of the hardship clause with the provisions of a termination clause. For example, a termination clause may make a contract terminable only upon a serious breach by a party. If the parties do not intend a breach of an obligation to renegotiate or to adapt the contract as justifying termination (see paragraph 45, below) such a breach should be excluded from the termination clause.

1. Procedure for renegotiations

(a) Notification

28. Upon the occurrence of a hardship situation the party invoking the clause should be obligated to notify the other party of it and of his intention to invoke the clause. The notification should be required to be made without undue delay after the invoking party becomes aware of it. The notification should not be postponed even if the extent or character of the adaptation sought cannot be determined at the time of notification.

29. The contract should require the notification to be in writing, and to set forth relevant details concerning the change in circumstances and its consequences as to enable the other party to evaluate the situation. The contract may also require that, if possible, the notice should indicate the nature of the adaptation sought.

30. Upon receipt of the notification, the other party should be obligated to confirm the subject, the ground, the date and the place of renegotiations, without undue delay. If he is silent he should be deemed under the contract to have refused either to participate in the renegotiations or to renegotiate. If he

*See chapter "Settlement of disputes".
'See chapter "Termination"
should consider that the grounds set out are not sufficient to justify renegotiations, he should indicate the reasons for his conclusion. The contract may provide for the obligation of the party to participate in the renegotiations without his thereby conceding that there are grounds for the renegotiations or that the grounds alleged by the other party are sufficient for the adaptation sought. If the place or the date of the renegotiations proposed by one party are not acceptable to the other party he should make a counter-proposal within a specified time-limit set out in the contract, giving reasons why they are unacceptable.

31. The parties may wish to agree on one of the following consequences if the party entitled to invoke the hardship clause fails to give the required notice, or fails to give it on time:

(a) The party may lose his right to invoke the hardship clause. This approach may avoid the situation in which a party initially chooses not to seek an adaptation of the contract, but later tries to use the hardship circumstances to reduce or escape his obligations for reasons not related to those circumstances;

(b) If the party does not give the required notification within the time specified in the contract, he might remain entitled to invoke the clause, but be liable to compensate the other party for losses resulting from the delay.

(b) Guidelines for renegotiations

32. Parties may wish to facilitate the application of a hardship clause by following some guidelines which should be aimed at assisting parties in coming to a fair solution. They may, for example, only limit the restoration of their initial balance to the extent that it has become burdened by the hardship situation and that other terms of the original contract should, as far as possible, be followed. Other guidelines may include the following: that the principle of good faith in the execution of the contract should apply; that renegotiations should aim at the attainment of performance; that there should be no undue prejudice to either party arising from the adaptation or that the interests of the parties must be maintained proportionately.

(c) Time-limit for renegotiations

33. If the parties wish to confer some right upon one party in case of a failure to agree to the adaptation of the contract (e.g. to initiate judicial or arbitral proceedings) they should stipulate a time-limit within which the renegotiations should be concluded, whether successfully or unsuccessfully, as otherwise it would be difficult to determine when the parties fail to adapt the contract.

2. Failure to agree

(a) When failure to agree occurs

34. The contract should stipulate the time when failure to participate in the renegotiations or failure to agree to the adaptation of the contract would deem to occur. It may stipulate that failure occurs when the party who has been requested to participate in the renegotiations refuses to do so, or if he does not express his readiness to do so within a time-limit, or if the parties do not reach an agreement within a certain period of time after renegotiations have commenced (see paragraphs 30 and 33, above).

(b) Effect of failure to agree

35. It has been noted (see paragraphs 25-27, above) that parties may adopt one of the two approaches in drafting a renegotiation provision (i.e. participate in the renegotiations only, or renegotiate and reach an agreement). If they follow the latter approach, they may wish to provide for some of the following legal consequences in the event that they fail to agree on the proposals of a party for adaptation.

(i) Adaptation of the contract in judicial or arbitral proceedings

36. In the event of a failure to agree, the party entitled to invoke the renegotiations should be able to resort to judicial or arbitral proceedings to adapt the contract. In so far as the court or the arbitrator is concerned it should be noted that in some legal systems the jurisdiction of the court or the arbitrator is limited to a determination of the rights and duties of the parties arising from the contract. As such they may not have the competence to adapt a contract as this may be considered as creating new contractual rights and obligations for the parties and which may be outside their normal function.

37. Parties should choose a court or place of arbitration where the law applicable to the judicial or arbitral proceedings recognizes the competence of the court or arbitral tribunal to adapt the contract. In choosing the applicable law of the contract, the parties may wish to consider a legal system which does not prevent a court or an arbitrator from adapting contracts.

38. In addition, parties should empower the court or the arbitrator to adapt the contract on behalf of the parties. The following may be suggested as specific powers which the parties should confer on the tribunal: determination as to whether or not there are grounds for renegotiation; adaption of the contract (e.g., to readjust the contract as far as reasonable in the interests of the parties); termination (in whole or in part) in the event where the contract cannot be adapted; determination of the legal effects of termination (the guidelines suggested in paragraph 32, above, should also apply here). However, in deciding whether to empower a court to adapt the contract parties should consider whether there are mandatory limitations on the competence of the court to adapt contracts.

39. On the other hand, arbitral proceedings are, generally speaking, less formal and more flexible, and there are less mandatory limitations in regard to their competence than in regard to that of the courts. Therefore, it may be preferable to resort to arbitration for the adaption of contracts. Moreover, arbitrators may be chosen for their expertise in construction law and practice and hence may be better equipped for adapting the contract to the satisfaction of both parties. As such, parties may prefer arbitration as the appropriate form of dispute settlement where parties fail to agree. If arbitral proceedings are contemplated, parties may find it advisable to include special provisions for the adaptation of contracts (see paragraph 38, above) either in a general arbitration clause dealing with other disputes (if such a clause is contemplated), or in a special arbitration clause dealing with adaption.

40. The contract should provide for the effect of the court decision or the arbitral award: the adapted terms should be considered as new contractual terms to be substituted for the original ones and be incorporated in the original contract. The parties should be obligated to comply with the new terms.

41. In the usual type of court decision or arbitral award, the tribunal decides on the rights and obligations of the parties under the contract and the decision or award can be
enforced. However, when a court or an arbitral tribunal adapts a contract, the decision or award simply creates new contractual terms to be substituted for or added to the original ones. This decision or the award is therefore not immediately enforceable, although the new contractual terms contained in the decision or award are binding on the parties. If a party breaches a new contractual term and judicial or arbitral proceedings are initiated for the breach, the judge or the arbitrator has to consider the question of the recognition of the decision or the award which adapted the contract. The recognition of the new contractual terms may encounter difficulties if the court or arbitrator asked to recognize the decision or the award adapting the contract cannot under the law applicable to such judicial or arbitral proceedings recognize such a decision or an award.

42. A method of avoiding the above-mentioned difficulties is to resort to a court or an arbitral tribunal in the same country both for the adaptation of the contract, and for breach of the new contractual terms created by the adaptation.

(ii) Adaptation of the contract other than by court or arbitrator - a third party

43. Another possible approach in overcoming the difficulties posed by the lack of jurisdiction of a court or an arbitrator to adapt a contract is to appoint a third party (not to be regarded as an arbitrator) to do it. The third party is to be empowered by the parties to modify the contract (see paragraph 38, above). The advantage of this approach over resort to court or arbitration is that the jurisdictional limitations (noted above) placed upon a court or an arbitrator may not be applicable to a third party, who is acting on the basis of authority granted by the parties.

44. This approach may, however, have some disadvantages. While almost all legal systems contain special legal rules on arbitration which ensure that arbitration proceedings are conducted fairly and lead to an arbitral award, many legal systems do not have special rules regulating the conduct of third persons, who are not arbitrators, deciding on such matters as the adaptation of contract, and in particular do not have rules to ensure the giving of decisions by third persons. Decisions of such third persons will be open to challenge on the basis of general rules of the applicable law such as those relating to the abuse of authority by a person to whom parties to a contract have granted authority. Such general rules, however, may not resolve all the problems which may arise under this procedure. The parties may, therefore, have to rely heavily on the good faith and competence of the third party.

(iii) Termination

45. The parties may wish to limit the possibility of terminating the contract only to exceptional cases where other solutions in respect of the failure to agree upon the adaptation of the contract are inadequate. In principle the right to terminate the contract should be exercised only if the adaptation of the contract in judicial or arbitral proceedings or by a third party has failed or is impossible. Termination should not generally be permitted before an attempt at renegotiation has been made and has failed. Even in cases where the only possible solution to the situation would be the termination of the contract it is advisable to authorize a court or an arbitrator or a third party to terminate the contract rather than allow a party to do so himself. In this way the ground for the termination may be verified and a settlement of complex problems concerning the consequences of the termination may be effected.

3. Status of the contract during renegotiations

46. The parties should spell out the position of the contract during the renegotiations. The parties should consider whether the execution of the contract should continue during the renegotiations or whether the performance is to be suspended during this period. Generally, an interruption in the construction can cause serious prejudice to either party and it would, therefore, be preferable for both parties to continue to fulfill their obligations during the renegotiations. The mere fact that higher costs would be incurred by the contractor and that this is the subject to be resolved by the renegotiations should not justify suspension of performance of the contract.

4. Normalization of circumstances

47. As renegotiation is required only upon a change of circumstances, provision should be made as to what should happen if circumstances return to normal. A problem arises when the situation is not exactly back to its original position. Here, to the extent possible, the original terms and conditions of the contract should be restored to take account of the extent of normalization of circumstances. The parties may therefore agree upon a procedure for renegotiating the consequences of a return to normality.

See chapter "Suspension".

[A/CN.9/WG.V/WP.9/Add.5]a

CHAPTER XXXVIII. TERMINATION OF CONTRACT

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a16 March 1983. Referred to in Report, para. 90 (part one, A).
3. When drafting a provision on termination the parties should take account of any mandatory rules of the applicable law on the subject. In certain legal systems rules may exist which restrict the freedom of the parties to agree upon termination provisions, or which otherwise regulate the termination of a contract. Moreover, the parties should be aware of any non-mandatory rules of applicable law relative to termination, and should consider whether these rules are sufficient and appropriate to regulate termination of the contract being negotiated. Very often, general legal rules on termination are ill-suited to the termination of long-term and complex industrial works contracts.

4. The parties should consider termination in relation to other remedies under the contract or applicable law for a failure of performance, such as requiring performance in accordance with the contract, requiring defects in performance to be remedied, renegotiating and varying contractual provisions, and damages. These remedies are discussed in other sections of this Guide. The parties may wish to reserve the remedy of termination, in particular when construction is in progress (see paragraph 11, below), for situations in which such other remedies are not available or are inadequate by themselves.

5. Under most legal systems it is possible for the parties to a contract to agree to terminate the contract. While some legal systems specify the form which such an agreement must take, it is advisable for the contract to specify that an agreement to terminate it must be in writing. A detailed discussion of the drafting and contents of an agreement to terminate is beyond the scope of this Guide.

B. Extent of termination

6. The word “termination” is used in this Guide in preference to other terms (such as “cancellation,” “recession” or “annulment”) which may be closely linked with particular legal systems and which may be thought to carry with them certain legal rules and consequences which exist in those systems. As conceived in this Guide, termination does not refer to a complete abrogation of the contract from its beginning or in its entirety. Rather, termination refers to a cessation of the obligations of both parties to perform (e.g. the obligations of the contractor to do the work and the obligations of the purchaser to pay the price) as of the time of termination. The contract will not be able to be terminated in respect of obligations which have already been performed, since this would require each party to return what he has received from the other. This is not possible in an industrial works contract because the purchaser will not be able to return to the contractor the portion of the works which have been constructed on the purchaser’s land.

7. Moreover, the concept of termination as used in this Guide does not imply that all rights and obligations under the contract cease to be effective upon termination. The parties will wish certain of these rights and obligations to remain in effect even after termination, such as those which regulate the termination itself (see section E, below), certain rights and obligations in respect of performance which has occurred prior to termination (e.g. damages for breaches occurring prior to termination, and guarantees in respect of work which has been done), and other obligations (e.g. confidentiality and the settlement of disputes). In order to ensure that such rights and obligations remain in force, it is advisable for the contract expressly to provide that they are to survive the termination (see paragraph 92, below).

A. General remarks

1. Termination of an industrial works contract, particularly during the construction phase (see paragraph 11, below), will cause significant difficulties for both parties. Both parties will have made substantial investments of finances, resources and time in the project. Upon termination, the contractor will have to stop his work, remove his personnel and equipment from the site, and discharge himself from a frequently complex web of contractual relationships with subcontractors and suppliers (see paragraph 76, below). The purchaser will have to find and engage another contractor to complete the project (see paragraph 72, below), and the work is likely to be delayed for a significant amount of time. The financial costs of terminating an industrial works contract are high. For these reasons, the remedy of termination is infrequently used by parties to industrial works contracts, and is usually invoked only as a last resort.

2. However, no matter how much planning and foresight the parties might exercise at the pre-contractual stage, and despite the parties’ good faith and the expectations of full performance with which they enter into the contract, circumstances may arise which make it prudent or necessary to terminate the contract before it has been completely executed. Therefore, parties negotiating an industrial works contract should devote serious consideration to the subject of termination, and should include a clearly-drafted termination provision in the contract in order to provide for an orderly and equitable termination in the event such circumstances arise.

The apportionment of these costs between the parties is discussed in section E, 6.

3. See paras. 58-62 concerning the time of termination.
8. In many cases a contractor may fail or be prevented by an impediment from performing only a portion of his remaining obligations under the contract. The parties should consider whether, in such cases, the purchaser should have the option of terminating the balance of the contract in its entirety or only the portion which the contractor failed or was unable to perform. The following paragraphs consider this question.

9. If the contractor fails to perform a portion of the work, it might be possible for the purchaser to bring in another contractor to complete or remedy that portion, keeping the original contractor bound to complete the balance of the work. In very many cases, however, this will not be feasible, as, for example, when the work in question involves a unique design or construction techniques with which a new contractor would not be familiar, or if a new contractor would not find it profitable to equip and prepare himself to perform only that portion of the work. Moreover, a new contractor will often be unwilling to enter the site and perform work while the original contractor is still present. In addition, in some types of contracts, particularly turnkey or product-in-hand contracts, the various functions which the contractor is obliged to perform may be so interlinked that it is not possible to terminate only a portion of the contract. In these cases, termination of the entire balance of the contract may be the only feasible remedy.

10. In some situations the purchaser may not wish to terminate the entire balance of the contract, even if he is entitled to do so, for a particular failure or inability of the contractor to perform. Such situations might be dealt with by other mechanisms, such as the recovery of damages, or variation of the work (see chapter "Variations"). If the purchaser wishes to bring in a new contractor to perform only the portion of the work which the original contractor did not perform, he may do so by a variation deleting that portion from the work to be performed by the original contractor, or by terminating the contract only in respect of that portion.

C. Grounds for termination

11. Due to the extreme consequences for both parties of the termination of an industrial works contract, termination should be chosen as a remedy (particularly during the construction phase) only in serious situations and used only as a last resort when continuation of the contract is likely to cause still greater loss to the terminating party, and when other means of relieving the circumstances giving rise to the termination have failed or are ineffective.

12. However, in a contract in which the contractor is to perform services after the works have been constructed (e.g. supplying spare parts, transferring technology, or performing maintenance services), the parties may consider whether the purchaser should have greater flexibility to terminate the contract after construction has been completed than he has during the construction phase. Circumstances and issues which pertain to obligations which are to be performed after construction has been completed differ from those which pertain to the construction phase. For example, when the works have been constructed, the purchaser will receive a completed plant and the contractor will be entitled to be paid for the work done. The hardship resulting from termination in such cases is not comparable with that which occurs when one party or the other is burdened with a partially completed industrial plant which is of no use.

13. The following paragraphs suggest various grounds for termination which parties involved in contract negotiations should consider for inclusion in their contracts.

1. Unilateral termination by the purchaser
   (a) Breach of contractual obligation by the contractor

14. Serious contractual breaches by the contractor should justify termination by the purchaser. Not every breach should be considered serious enough to warrant termination. During construction work breaches frequently occur which are either trivial, or can be easily remedied, or which will not affect the progress or quality of the completed work. Breaches of this nature should not justify termination.

15. In order to ensure that the remedy of termination is available only for breaches which entail serious consequences, the termination clause should require that the breaches be of such a character. The following framework might be used in order to achieve this. First, the termination clause could enumerate certain breaches which will always be considered sufficiently serious to justify termination, such as abandonment of the contract by the contractor. Second, the clause could enumerate certain additional breaches which would justify termination if they are likely to produce serious consequences (e.g. delay in completion or work of defective or inferior quality). Examples of such breaches are discussed in the following paragraphs. To avoid the hazard of precluding certain grounds fromjustifying termination by inadvertently excluding them form the enumeration, the enumeration might be coupled with a general residuary provision to the effect that any other breach which has not been specifically mentioned can justify termination if it produces serious consequences for the purchaser. However, such a residuary provision suffers from the fact that its vagueness opens the clause to abuse and is likely to lead to disputes over whether termination is permissible in particular cases. A preferable approach may be to provide that any other breach by the contractor will justify termination by the purchaser if the contractor does not remedy it within a specified period of time after having been notified to do so by the purchaser. Some industrial works contracts permit the purchaser to terminate for any breach by the contractor if it is "persistent or flagrant". Thus, although an individual breach may not be serious, persistence in committing such a breach may itself substantially prejudice the performance of the work, or may portend chronic problems with performance by the contractor, and would therefore warrant termination.

   (i) Abandonment of contract; delay in construction

16. A failure by the contractor to commence construction at all, or his express abandonment of the construction, should entitle the purchaser to terminate the contract, as should an interruption of construction which evidences the contractor's intention to abandon the construction.

17. In certain circumstances delays during construction may also justify termination by the purchaser. It should be noted, however, that delays in the construction of complex industrial works are virtually inevitable. In many cases the contractor will be able to hire labour or take other measures to perform the balance of his work more expeditiously, and make up the time lost during the delay, so that the work can be completed on time. The parties may conclude that delays which do not prevent the contractor from meeting the completion date should not justify termination by the purchaser.

   In considering this issue the parties should take into account any ability of the contractor to obtain an extension of the completion date.
18. Works contracts often provide for a construction schedule or programme which, when several contractors are involved, will serve to co-ordinate various phases of the construction work (such as the supply of equipment and materials and the performance of work by other contractors). A failure by a contractor to meet intermediate time limits specified in the schedule may not prevent the final completion date from being met, but may result in the liability of the purchaser to other contractors on the project who suffer financial loss because of the failure in co-ordination (e.g. other contractors who incur overhead costs while having to wait to commence their work as a result of the contractor's delay). Such circumstances may be more satisfactorily dealt with by the payment of damages, liquidated and actual, by the contractor to the purchaser, than by termination.

19. On the other hand, a failure by the contractor to make satisfactory progress with his work may prevent the completion date from being met. The parties may consider it appropriate to permit the purchaser to terminate the contract in such cases. There are several ways in which such a provision could be formulated. First, the termination clause could provide that the purchaser may terminate after the accumulation of a specified amount of unexcused delay by the contractor. Second, when delays by the contractor oblige him to pay liquidated damages to the purchaser, termination may be permitted after a specified amount of liquidated damages has accumulated.

20. Third, the clause may be phrased more generally, and permit the purchaser to terminate if the contractor fails to proceed with "due diligence", (perhaps coupled with the condition that the failure makes it unlikely that the contractor will be able to meet the completion date or that date as extended). Such a generalized formulation suffers from vagueness and therefore might be considered to be less preferable than the first two approaches. On the other hand, if the contractor is subject to a construction schedule, the schedule might be used as one indication (although not conclusive evidence) of the diligence with which the contractor has proceeded.

21. A termination provision based upon failure to proceed with due diligence may be conditioned upon notification being given by the purchaser to the contractor. The purchaser would have the right to terminate upon failure by the contractor to restore a satisfactory rate of progress within a specified period of time after the notice. Purchasers should be aware, however, of the possibility that with this type of provision the contractor may be able to improve his progress temporarily in order to forestall the termination, and then retard his progress once again, requiring a new notice by the purchaser, followed by a repetition of this pattern. To avoid this situation, the purchaser might be permitted to terminate upon a new delay by the contractor after the first notice, without further notification.

22. Whichever approach is adopted, it would be desirable for an engineer or project manager to certify the existence and duration of each delay, in order to minimize the possibility of disputes as to these matters. This is particularly true in the case of a failure of the contractor to proceed with due diligence, because of the vagueness of this approach and its susceptibility to disputes.

(ii) Defects in performance

23. The purchaser should be able to terminate the contract if the work performed by the contractor is seriously defective (e.g. if the works are not of the agreed quality or do not function in accordance with contractual stipulations), and if the contractor fails to remedy these defects within a specified period of time after having been notified of the defects by the purchaser. In this connection the parties should bear in mind the obligations of the contractor under guarantee provisions of the contract (see chapter "Guarantees"). The contract should be as specific as possible in enumerating the defects which will justify termination.

(iii) Failure to obey proper instructions of the engineer

24. In those contracts which provide for an engineer to play a supervisory role (see chapter "Engineer") the parties may wish to permit the purchaser to terminate the contract if the contractor fails to obey proper instructions of the engineer concerning matters of significance to the progress or outcome of the work. The parties may also consider it appropriate to permit the purchaser to terminate if the contractor persistently fails to obey even minor instructions of the engineer. In either case, notification by the purchaser and a failure by the contractor to remedy his behaviour should be pre-requisites to termination.

(iv) Breach of obligations concerning the assignment of contracts and subcontracting

25. As discussed in the chapter "Assignment", under the contract the contractor usually may not, without the purchaser's consent, assign the contract so as to substitute another party for itself. The parties may well regard an unauthorized attempt to assign by the contractor to a serious matter, comparable to abandonment of the contract, and permit the purchaser to terminate in such an event.

26. Subcontracting, on the other hand, is very common in the construction of industrial works. In general, the contractor may subcontract unless he is prohibited from doing so under the contract. However, as discussed in the chapter on "Third parties employed in execution of the contract", some subcontracting may be subject to conditions or restrictions.

27. If the contract contains no express restrictions on subcontracting, the fact that the contractor has subcontracted should in itself provide no grounds for termination.

28. Any violation of contractual provisions restricting or conditioning the contractor's ability to subcontract might be considered to be serious enough to justify termination by the purchaser. Alternatively, the parties may choose to differentiate between restrictions the breach of which would significantly prejudice the purchaser and restrictions which are not so serious. For example, a contract may permit the contractor to subcontract only with subcontractors who have been approved by the purchaser. Subcontracting by the contractor without such approval might be considered serious enough to permit the purchaser to terminate. On the other hand, if the contract merely requires the contractor to advise the purchaser of the identity of subcontractors, without allowing the purchaser to influence the choice of subcontractors, a violation of this provision may be thought not to be so serious as to justify termination. A breach by the contractor of a provision
prohibiting him from subcontracting the entire construction
should normally justify termination by the purchaser.

29. The parties may wish to permit the purchaser to terminate
only after he has notified the contractor, and the
contractor has failed to terminate the subcontract within a
specified time period after notice. On the other hand, termination
might be permitted immediately if the contractor
improperly assigns the contract (see paragraph 25, above).

(v) Breach of other obligations

30. In a particular contract there may be other contractual
obligations the breach of which may produce consequences
which are serious enough to justify termination by the
purchaser. If so they should be precisely identified in the
contract.

(b) Bankruptcy or insolvency of the contractor

31. In most legal systems the contract and its performance
will be subject to mandatory legal rules in the event of the
bankruptcy of a party. The parties should take account of the
relevant bankruptcy laws in drafting termination provisions.
In particular, under some bankruptcy laws, even if the parties
wish to continue with performance of a contract after
bankruptcy, their ability to do so may be severely restricted.

32. The bankruptcy or insolvency of the contractor will
seriously threaten the carrying out of the construction. Under
most legal systems, the assets of the bankrupt, including his
rights and obligations under the contract, will pass to the
control of a trustee in bankruptcy or comparable officer. This
officer will usually cease carrying on the business of the
bankrupt in the ordinary course, except to the extent necessitated by the bankruptcy proceedings. In addition, at
least during the pendency of the bankruptcy proceedings, the
contractor will be severely restricted in his ability to sub-
contract or to purchase from third parties equipment or
supplies needed to carry out the work, or to make current
payments for them. The bankruptcy of the contractor, therefore, should be a ground for terminating the contract.

33. The purchaser should have the right to terminate
immediately upon the bankruptcy of the contractor so as to
enable him to take necessary actions to protect his position,
particularly vis-à-vis other creditors of the contractor. Further-
more, the possibility of immediate termination might be
important to enable the purchaser to prevent the contractor
from incurring additional obligations to third parties for
which the purchaser would be responsible.

34. The parties should consider providing that not only an
adjudication of bankruptcy, but also the commencement of
bankruptcy proceedings by or against the contractor, con-
tinutes a ground for termination. Under most legal systems
the institution of such proceedings can seriously disrupt the
carrying out of the work by the contractor.

35. The parties should designate as a ground for termination
not only bankruptcy, but also similar or related proceedings
to which the contractor may be subject, and which would
significantly interfere with his performance of the contract
(e.g. liquidation, insolvency, assignment of assets and compar-
able proceedings under relevant law).

36. When the contract requires the contractor to furnish a
performance guarantee, the parties may wish to consider
permitting the purchaser to terminate if the guarantor
becomes subject to the proceedings or adjudications described
above, and the contractor fails to provide a new performance
guarantee within a stipulated time.

(c) Termination for convenience

37. Some industrial works contracts permit the purchaser
to terminate the contract at its convenience. A termination
for convenience need not be justified by any particular
circumstances; the purchaser is permitted to terminate whenever he wishes to do so. In practice this right is confined to
purchasers who are Governments or government entities.

38. The right to terminate for convenience may be coupled
with other specific grounds. If a purchaser purports to
terminate under one of those specific grounds and if it is
subsequently determined that termination under that ground
was improper, the termination might, under the contract,
nevertheless be justifiable as a termination for convenience.
However, the rights and obligations of the parties may differ
according to whether termination is based upon a serious
ground or is for the convenience of the purchaser. The
contract should make it clear that the parties are subject only
to the rights and obligations which are appropriate to the
grounds under which the termination properly occurred.

(d) Other grounds

39. The grounds discussed in the foregoing paragraphs
which might justify termination by the purchaser are intended
to be illustrative only. In a particular contract there may exist
other grounds which the parties consider enough to justify
termination.

2. Unilateral termination by the contractor

(a) Breach of contractual obligation by the purchaser

40. As was the case with termination of the contract by the
purchaser upon a breach by the contractor, the contractor
should be entitled to terminate in the event of a breach of a
contractual provision by the purchaser if the breach entails
serious consequences for the contractor.

41. The purchaser’s principal obligation under the contract
is to pay the agreed price. A breach of this obligation by the
purchaser should entitle the contractor to terminate the
contract in some situations, as will be discussed below.

42. The purchaser will also have obligations which are
related to the contractor’s right to payment, such as providing
a bank guarantee, and obligations which affect this right, such
as those relating to interim performance tests, the issuance of
interim completion of payment certificates or the acceptance
of completed work. A breach by the purchaser of such
obligations might entail serious consequences for the con-
tactor, for example if he finances his work in part with the
interim payments and cannot proceed with the work in the
absence of these payments. The purchaser will have other
obligations under the contract, such as making the site
available to the contractor, and in the case of a partial-
turnkey contract, obligations to perform or to provide for the
performance of some of the work. The ability of the
contractor to terminate for breaches of such obligations is
discussed in the following paragraphs.

(i) Non-payment

43. Non-payment by the purchaser of sums due to the
contractor should be regarded as a serious breach and should
entitle the contractor to terminate the contract. In many
contracts payments become due upon certification by an
engineer, and the breach of the purchaser will occur upon his
non-payment within the time allowed of the amount certified.
Of course, termination should be possible only if the

See paras. 89-90.
purchaser fails to pay the sum which is due after setting off amounts owed by the contractor to the purchaser, such as costs of repairing defective work, liquidated damages payable by the contractor, and authorized direct payment made by the purchaser to subcontractors.

44. The parties may wish to consider the advisability of giving the contractor the option to suspend the work as an additional and less extreme measure for dealing with non-payment (see chapter “Suspension”).

45. It is advisable to condition the right of the contractor to suspend or terminate for non-payment upon his giving notice to the purchaser and the purchaser’s failure to make payment within a specified time limit after the notice.

46. The parties may wish to consider including in the contract measures to protect the contractor’s right to payment which are less disruptive than suspension and less severe than termination. For example, the contract could provide for periods of escalating interest payments after which, if the purchaser still has not paid, the contractor would be entitled to suspend or terminate. Also, in the case of a dispute concerning the contractor’s right to payment, the purchaser might be permitted to avoid termination or suspension by providing a bond from an appropriate financial institution guaranteeing payment if it is found to be owed.

(ii) Breaches affecting the contractor’s right to payment

47. Certain breaches by the purchaser could affect the contractor’s right to receive payment. These could include an unjustifiable interference with or failure of acceptance by the purchaser of a completed stage of work, an unjustifiable interference with the issuance of a performance or payment certificate by the engineer or other certifier or failure to issue a certificate for which the purchaser is responsible. Such breaches may be made grounds for suspension and/or termination by the contractor. Again, it is advisable to permit termination only after a failure by the purchaser to cure his breach within a specified time after notification.

(iii) Interruption or interference with the contractor’s work

48. Termination by the contractor might be warranted if the purchaser without justification significantly interferes with or obstructs the contractor’s work, or if the contractor’s work is interrupted due to a cause for which the purchaser is responsible, and the interruption persists for a certain amount of time. Obstruction could occur as a result of actions unrelated to the contract as well as by failures to act in accordance with the contract. It could occur, for example, if the purchaser fails to make the site or portions of the site available to the contractor on time. In contracts in which the purchaser has obligations with respect to the supply of materials or construction, obstruction could occur from a failure to perform these obligations. If the obstruction or interruption relates to all or substantially all of the work to be performed by the contractor, then termination would probably be warranted. Termination may also be warranted if the obstruction or interruption relates only to a portion of the work, but if completion of that portion is necessary before further work can be performed.

(b) Bankruptcy or insolvency of the purchaser

49. The contractor should be able to terminate the contract if the purchaser becomes bankrupt or insolvent. Considerations similar to those discussed in paragraphs 31-35, above, concerning the bankruptcy or insolvency of the contractor, are applicable here.

3. Prevention of performance due to an exempting impediment

50. During the course of an industrial works project events can occur which physically or legally prevent the contractor from performing his obligations under the contract. The contractor will be exempt from liability for failure to perform if the events are covered by the exemption clause (in this Guide these events are called “exempting impediments”; see chapter “Exemptions”). The contract should be terminable if the inability to perform will be permanent or if it will persist for an excessive period of time. The following paragraphs consider ways in which this may be accomplished.

51. When the contractor encounters an exempting impediment which prevents him from performing, he should be obliged to notify the purchaser immediately or within a reasonable time thereafter. The contract could then obligate the parties to meet in order to consider the likely extent and duration of the impediment and its effects, and to decide how to deal with them. If the inability of the contractor to perform is not expected to persist for an excessive amount of time, the parties could agree simply to suspend the contract until the work can be resumed. If it will be permanent, or last for an excessive amount of time, the parties could consider whether the scope of construction or specification of equipment could be modified so as to avoid the impediment (see chapters “Change in scope and quality of works” and “Variations”). The contract might be made terminable only if the impediment or its effects cannot otherwise be avoided or overcome.

52. Alternatively, the termination clause could provide that an inability of the contractor to perform due to an exempting impediment would, upon notice, permit suspension of the contract, and that if the suspension persists for a period of time specified in the clause, the contract would be terminable.

53. In extreme cases, when it is clear from the onset of the impediment that the inability of the contractor to perform will be permanent or will persist for an excessive period of time, the contract might be terminable without requiring a delay. However, even in such extreme cases it would seem that nothing would be lost by requiring the parties to meet and explore whether the impediment or its effects can be avoided or overcome, before permitting termination.

54. The parties should consider which party should be able to suspend or terminate in the event of an exempting impediment. Often, an exempting impediment is beyond the control of both parties; in such a case either party should be able to suspend or terminate. However, an impediment may exempt the party who is prevented from performing his

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8The question of termination because of economic difficulties is discussed in the chapter “Hardship”.

9A failure to perform due to events which do not exempt the contractor constitutes a breach of contract, and termination for such a failure will be governed by the provision of the termination clause pertaining to breaches (see section C, 1).

10For a discussion of issues and practices concerning renegotiation in general, see chapter “Exemptions”.

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obligations, but be within the responsibility of the other party. It might be considered that the latter party should not be permitted to suspend or terminate, but that only the exempted party should be permitted to do so.

55. Performance by a party can be prevented by actions taken by a State. For example, the Government might requisition land needed for construction of the works, refuse or rescind import or export licenses, or prohibit performance of the contract by the party. Parties negotiating an industrial works contract should consider whether actions taken by a Government which prevent performance of the contract should justify termination, and if so, to what extent.

56. The question of whether such governmental restrictions should exempt a party from failure to perform is dealt with in the chapter "Exemptions". It would be reasonable to conclude that a governmental restriction which exempts a party from liability for the failure to perform should justify termination of the contract to the same extent as do other exempting impediments (see paragraphs 50-54, above).

57. Certain governmental restrictions might not under the contract exempt a party. In such cases the party who cannot perform is liable for breach of the contract. One approach which the parties might consider to deal with these restrictions is to treat them in the same manner as other breaches (see section C, 1 above, and note 10). In such cases a party would not be able to terminate if his performance were impeded by a non-exempting government restriction. On the other hand, the parties may consider that such government restrictions should be treated differently from other impediments, in that even if they are not considered to be exempting impediments, a party should not be compelled to risk violating a law or other governmental restriction by requiring him to perform; rather, the party should be able to choose to terminate the contract and pay damages to the other party. However, in order to avoid abuse of this right to terminate, its use might be limited to situations in which the duration of the restriction is unlimited, or, if the duration is fixed, it will persist for an excessive amount of time.

D. Procedure for termination

1. Time for termination

58. The contract should specify the time when a party becomes entitled to terminate the contract. Various approaches may be adopted in this regard. These include permitting a party to terminate immediately upon the occurrence of grounds for termination, or only after the lapse of a period of time following notice of such grounds.

59. As indicated in the sections of this chapter dealing with the various grounds of termination, it is usually desirable to require notification and the lapse of a period of time prior to termination, particularly when the ground for termination is a situation which can be remedied, avoided or overcome.14

60. It will usually be preferable for the termination clause to set forth a specific time period, rather than merely requiring the terminating party to wait a "reasonable time". A specific time period avoids uncertainty as to whether in a given case the time was reasonable. The appropriate length of time will vary depending upon the grounds invoked for termination; but this can be taken into account by setting forth different time periods for different grounds.

61. If it is the intention of the parties that performance may be suspended during the time period, then this should be expressly set forth in the contract. Otherwise the parties may be obligated to proceed with performance during this period.

62. The parties should consider whether a party should lose its rights to terminate if it does not exercise its right when it becomes entitled to do so (i.e. immediately upon the occurrence of a ground for termination or upon the lapse of a period of time). Four possible approaches exist in this regard. First, the termination clause could provide that the party loses its right to terminate if it does not do so immediately upon entitlement. (This will not usually be a desirable approach). Second, the clause could provide that the party loses its right if it does not terminate within a specified time period or within a reasonable time after entitlement (see paragraph 58, above). Third, the clause could permit a party to exercise a right to terminate at any time but provide that a delay of an excessive amount of time in doing so will require the terminating party to compensate the terminated party for any damages suffered as a result of the delay. Fourth, the clause could provide that a failure to terminate upon entitlement will result in a loss of the right in respect of certain grounds (perhaps, for example, the breach of an obligation concerning subcontracting (see paragraph 28, above)), but not others.

2. Notice

63. The contract should expressly require any notice to be given by one party to another to be in writing. It may also set forth requirements as to the contents of the notice, such as the requirement that the notice clearly specify the grounds for termination, and perhaps the measures which the non-terminating party must take in order to cure the grounds and the time period within which such measures must be taken. If an initial notice requires a non-performing party to perform or remedy a defect within a specified time period, the notice should state whether the termination will take place (upon a failure of the party to perform or remedy) automatically upon the expiration of the time period, or whether an additional notice of termination will be given at that time.

64. The contract should specify the method for delivering the notice to the non-terminating party, such as registered mail, telegram, telex or delivery by hand, and the time when the notice takes effect (e.g. upon receipt, or despatch). It should also specify the addresses of the parties to which all notices are to be sent.

3. Establishment of grounds

65. The parties should consider whether a party may terminate the contract upon its own assessment that grounds for termination exist, or whether the existence of grounds for termination must be verified by some third party. In contracts in which an engineer plays a supervisory role, certification of grounds by the engineer would help to avoid disputes as to the existence of such grounds. A determination or certification
by a third party of the existence of grounds for termination should not restrict the ability of a court or arbitral tribunal to determine the existence of such grounds.

66. In some legal systems a contract can be terminated only by judicial consent unless the contract expressly authorizes a party to terminate without such consent. Therefore, unless the parties desire termination to be subject to judicial authorization, it is advisable for the termination clause to specify that the contract may be terminated without requiring the consent of any court.

E. Rights and obligations of the parties upon termination

67. Difficulties connected with the termination of a works contract relate not only to the physical operations of winding up the works by the contractor and withdrawing from the site, but also to the reconciling of financial accounts between the parties, and the allocation of their rights and obligations.

68. As discussed below, some consequences of termination may differ depending upon whether or not the contract is terminated because of circumstances within the responsibility of a party (see note 12).

1. Cessation of work by the contractor

69. Upon termination by either party the obligation of the contractor with respect to construction should cease. While this might seem to be self-evident, it is nevertheless worthwhile for the termination clause to contain an express provision to that effect. Furthermore, it would be advantageous to specify that the contractor must cease issuing purchase orders, subcontracting or incurring other obligations to third parties in respect of the work.

70. In many instances it will not be feasible or advisable for the contractor simply to “lay down his tools” and leave the site at the moment termination takes effect. Certain operations in progress may have to be completed, and measures may have to be taken to protect or secure various elements of the partially completed works. It is therefore advisable for the contract to allow the contractor to take such measures as are necessary in connection with the stoppage of work, even after the termination date. The contract might go further and oblige the contractor to take such measures.

71. The contract should also expressly require the contractor and persons or firms employed by him to vacate the site without delay once all work has finally stopped, or when ordered to do so by the purchaser.

2. Completion of work by the purchaser

72. In most cases, when the purchaser terminates a works contract he will wish to make other arrangements to have the work completed. Often, the purchaser will wish to employ another contractor to complete the work. As discussed below (see paragraph 83), the costs of completing the work will in some cases be chargeable to the terminated contractor. The parties may therefore wish to consider having in the contract set forth requirements concerning the selection of a new contractor directed toward keeping these costs at a reasonable level. The contract could stipulate the extent to which the purchaser must mitigate or minimize the cost of completing the work.

3. Use and disposition of contractor’s equipment and materials

73. In the construction of some works it might be important for a purchaser or the new contractor to be able to use plant, equipment and materials belonging to the original contractor in order to continue the work. If so, the termination clause should expressly authorize this. The parties should also consider whether the purchaser should be charged a rental for this use, and the extent of the purchaser’s responsibility for the contractor’s equipment. One factor which may be relevant to these issues is whether the termination is due to circumstances within the responsibility of one party or the other (see note 12). The parties should also consider what the position should be if termination is due to exempting impediments (see chapter “Exemptions”).

74. The contract should also provide for the disposition of the contractor’s plant and construction equipment when the contractor stops work, or, if the purchaser is to use them, when the work is completed. In particular, if the plant and equipment are not to be used in continuing the construction or if the purchaser is not otherwise given rights in respect of them, it is important for the contractor to remove them from the site so as not to interfere with the completion of the work.

75. A number of arrangements are possible with respect to the disposition of the contractor’s plant and equipment when they are not to be used by the purchaser. For example, the contractor may be obligated to remove them from the site within a certain period of time. If he fails to do so, the purchaser could be empowered to have them removed at the contractor’s expense, or sell them through appropriate means and apply the proceeds toward sums owed to the purchaser by the contractor. Alternatively, if the contractor fails to remove his plant and equipment, ownership of them could be deemed to pass to the purchaser in the nature of a contribution towards sums owed to the purchaser. The purchaser could also be given a right to retain the plant and equipment as security against sums due to him from the contractor, or to purchase them at a price to be agreed by the parties or established by an independent valuer, or at its market value. Parties should be aware, however, that these approaches may be subject to or restricted by mandatory rules of applicable law; parties should therefore take such rules into account in drafting provisions such as these.

4. Assignment of third-party contracts and assumption of liability

76. Very often when termination occurs there will exist outstanding contracts which the contractor has entered into in his own name with subcontractors and suppliers. If the work is to be completed by the purchaser or by another contractor, the purchaser may wish to take over some of these contracts. Alternatively, he or the new contractor may wish to enter into new contracts with these subcontractors or suppliers. This may be the case if the original contract was not assignable, or if the purchaser or new contractor does not wish to take over all of the obligations due from the terminated contractor to the subcontractors or suppliers by taking an assignment of the contracts. The conclusion of such new contracts will be practicable only if the subcontractors or suppliers are released from their contracts with the contractor. Therefore parties should consider obligating the contractor to assign such contracts, if assignment is possible, or to terminate them, in accordance with the instruction of the purchaser.

77. When assignment of a contract or a new contract with a subcontractor or supplier is contemplated, difficulties may arise because of sums owed to such third parties by the contractor. The third party may not wish to continue his participation in the project unless past sums owed to him by the original contractor are paid. Furthermore, the third party may refuse to deliver items which were contracted for prior to termination but for which payment has not yet been made, or even take back materials which have already been delivered. The purchaser may therefore want the authority to pay the third party directly for past-due sums owed by the original contractor, and charge these payments against the original contractor. If the purchaser accepts an assignment of the third party contract, he will under most legal systems be obligated to pay these past-due sums. The contract should expressly authorize such direct payments and permit them to be charged against the contractor.

78. The contractor could incur penalties or other expenses as a consequence of terminating his contracts with third parties. In addition, the purchaser may have contracted with other contractors or suppliers, and these contracts will have to be terminated if it is impossible to complete the work, possibly resulting in penalties or expenses. The parties should consider who is to bear these expenses. If termination was due to circumstances within the responsibility of one party or the other, one way to resolve this question is to have the responsible party bear the expenses. If termination was due to a situation not within the responsibility of either party, each party could bear his own expenses, or they could be shared by the parties.

5. Drawings and descriptive documents

79. If the purchaser intends to complete the work left unfinished by the terminated contractor it will be important for the purchaser to have the drawings, designs, calculations, descriptions, documentation for know-how and engineering and other materials relating to the work which has been completed by the contractor, as well as for work yet to be completed. The contract should therefore obligate the contractor upon termination to deliver to the purchaser such of these materials as are in the possession of the contractor. The purchaser might be required to compensate the contractor for materials relating to work in respect of which the contractor has not been or will not be paid.

6. Payments to be made by one party to the other

80. The contract should establish the financial rights and obligations of each party upon termination. In principle this will usually depend upon whether termination is due to circumstances within the responsibility of one party or the other.

81. The termination clause should provide that upon termination by either party the purchaser should make no further payments to the contractor—even payments which are then outstanding for work which has been completed. These sums should be credited to the contractor in the final reckoning.

   (a) Termination arising from circumstances within the responsibility of the contractor

82. If the contract is terminated for grounds within the responsibility (see note 12) of the contractor he should not be entitled to payment for work which has not yet performed. However, it will usually be considered appropriate for him to receive some payment for work which he performed satisfactorily prior to termination. Such payment would include the costs incurred by the contractor in performing this work, as well as the cost of materials which have been paid for by the contractor and delivered to the site but not yet incorporated in the works, constructional or temporary works which will remain on the site and continue to be of use in completing the works and reimbursement for obligations reasonably incurred by the contractor prior to termination (such as materials ordered). The parties should consider whether and in what circumstances the contractor should also be entitled to an amount over and above his costs in respect of the work performed, in the nature of a fee or profit. If the work performed by the contractor is not of use or value to the purchaser, the parties may consider that the purchaser should not be obligated to pay any sum for that work.

83. On the purchaser's side, he may incur expenses in connection with the termination which he would not have incurred had the contract not been terminated and had the work been completed by the contractor. For example, the purchaser may have to have temporary work done to secure or protect the partially completed works until construction can resume, or, if it is impossible to complete the works, he may incur penalties or expenses in connection with the termination of contracts with other contractors or suppliers. In addition, the cost of completing the work not performed by the terminated contractor could very likely exceed the amount which under the contract would have been due to the contractor in respect of that work. If termination is due to circumstances within the responsibility of the contractor, the parties may consider it reasonable for the contractor to be obligated to the purchaser for these costs.

84. The purchaser could suffer other losses in connection with the termination. For example, the process of selecting and employing a new contractor to complete the work could delay its completion. So too could the time required for the new contractor to integrate himself in the project and continue from where the terminated contractor left off. The parties might consider that these and other losses suffered by the purchaser in connection with the termination should be compensated by the contractor. In addition, any damages owed by the contractor to the purchaser should be taken account of in the final reckoning (see chapter "Damages").

85. The costs which the purchaser incurs to complete the work will not be known until the work is in fact completed. Moreover, damages owed by the contractor for defects in work performed may not be finally determined until the expiration of the guarantee period. For these reasons, the parties might agree that the final reckoning, and the payment of any sum due to the contractor from the purchaser, should not occur until the work has been completed, the guarantee period has expired, and all expenses and damages can be calculated.

   (b) Termination arising from circumstances within the responsibility of the purchaser

86. If the termination occurs due to circumstances within the responsibility of the purchaser, the contractor should receive his costs and a fee for the work which he has satisfactorily completed, and reimbursement for obligations reasonably incurred in anticipation of completing the works (as for materials ordered). The parties may consider that he should also be reimbursed for his extra expenses occasioned by the termination. These could include, for example, the costs of any measures required to be taken or requested by the purchaser to secure or protect the works, the cost of
repatriating his personnel and equipment\(^{16}\) and damages for terminating contracts with subcontractors or other third parties.

87. The contractor should be entitled to compensation for other losses, such as the profit he would have earned if he were able to complete the entire contract. The amount of such compensation could be delimited, such as by restricting the contractor's entitlement to the contract price less the costs saved to the contractor by not having to perform the rest of the contract, or to a liquidated sum.

(c) *Termination arising from circumstances not within the responsibility of either party*

88. If the contract is terminated for reasons outside the responsibility of either party the contractor should normally be entitled to his costs and a fee in respect of the work satisfactorily completed, and reimbursement for obligations reasonably incurred in the expectation of completing the contract. The parties should consider, however, the most equitable way to deal with their respective expenses occasioned by the termination. One possibility is to share these expenses equally or in accordance with an agreed formula. Another possibility is for each party to bear his own expenses. The purchaser should not be required to compensate the contractor for profit lost by being unable to complete the contract.

(d) *Termination for convenience*

89. Contracts permitting a purchaser to terminate at his convenience generally require him to compensate the contractor fully for work performed prior to the termination, including reasonable profit for that work, as well as for costs incurred by the contractor incidental to the termination, such as the costs of repatriating his equipment and personnel (to the extent that such costs are not already included in the price), the costs of terminating his contracts with subcontractors and suppliers, and the cost of items in the process of manufacture or delivered to the site but not yet paid for. On the other hand, the contractor is usually not entitled to be compensated for lost profit on the portion of the contract remaining to be performed.

90. Under some contracts at the time when the contract is terminated for convenience the purchaser may have received the design for the works from the contractor, but this may not yet have been adequately reflected in the price which would be due to the contractor if this price were based upon the work which the contractor had performed. In cases in which this might be a problem, the contract could specify that the purchaser must compensate the contractor for the design insofar as such compensation is not otherwise reflected in the price due to the contractor.

7. *Parties' rights to damages and other remedies*

91. The parties should carefully consider the relationship between remedies under the contract and remedies under the applicable law (see paragraph 5, above). The contract should state clearly whether a party is entitled to remedies both under the contract and the applicable law, or only to remedies under the contract.

92. In some legal systems termination of the contract might be interpreted as bringing to an end all contractual provisions, including those which the parties might wish to survive, such as the rights and obligations of the parties upon termination, guarantees for work performed, and provisions such as those concerning settlement of disputes and the preservation of confidentiality. The parties should take care to ensure that rights, obligations and remedies which they wish to survive do not lapse upon termination. To do so, the parties should specify in the contract those provisions which will survive and continue to bind the parties even after termination (see paragraph 7, above).