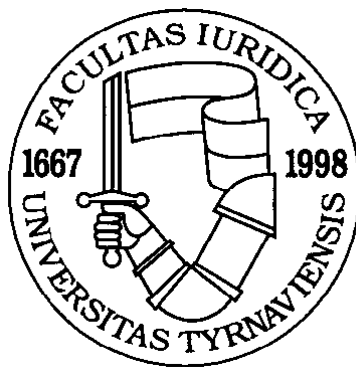


WORKBOOK ON EUROPEAN CONTRACT LAW

Timon Milan Solár



TRNAVA 2026

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Trnava 2026

Vydala: Trnavská univerzita v Trnave, Právnická fakulta

Počet strán: 96

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ISBN 978-80-568-0865-8

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PREFACE

The purpose of this workbook is to equip you with the 'common language' of European lawyers. In an increasingly integrated European Single Market, legal professionals can no longer rely solely on their national contract laws. Lawyers routinely face cross-border transactions where different legal concepts collide. In this workbook, we will use the Principles of European Contract Law (PECL) as a bridge to compare and understand the fundamental functions and principles of contract law. Where relevant, we will also discuss English contract law. After all, it is still one of the most influential legal systems in international business transactions and may often serve us as a useful example of different responses to the same problems.

Each part of this workbook focuses on a different aspect of contract law. It does not aim to cover all aspects of the law of contract comprehensively. Rather, the aim is to introduce you to the 'lifespan' of a contract. Each part begins with a practical scenario that introduces the main dilemmas of the topic. It then provides you with answers to these dilemmas by reference to the PECL and gives you an opportunity to practice your skills on different problem questions and model scenarios.

PART I: Introduction to Contracts

Consider the following scenario:

Beatrice and Benedick are old friends from high school. One Wednesday, after not seeing each other for a couple of years, they run into each other in a supermarket. Beatrice, eager to reconnect, says: 'Benedick, I am hosting a special dinner party this Friday. I am cooking my famous seafood paella. You must come! And please, bring those expensive fresh oysters from the local market! You always know how to pick the best ones.'

Benedick, who has always liked Beatrice, replies: 'I would love to! I promise I will be there at 8:00 PM with the oysters.' On Friday afternoon, Benedick goes to the local market and buys two dozen fresh oysters for €150. To ensure they stay fresh, he then pays €30 for a taxi to Beatrice's house. At 7:50 PM, while he is in the taxi just minutes away from her house, Beatrice sends him a text message: 'Sorry, still stuck at work. I don't think I can make it home in time. The dinner is cancelled. Let's do it next month.'

Benedick is furious. He has wasted money on the taxi, and he is now stuck with expensive fresh oysters that will spoil by tomorrow if not eaten. He demands that Beatrice pays him the €180 that he lost. Beatrice laughs and says: 'Relax, it was just a dinner among friends. It was not a business deal.'

Discussion: Is there an enforceable contract between Beatrice and Benedick?

- YES, it is a contract because...

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- NO, it is just a social, non-binding agreement because....

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1. What is a Contract?

We enter into contracts every day. Yet, defining a contract is more complex than it appears. As the introductory scenario illustrated, the line between a merely gratuitous promise and a legally binding contract may be thin. Different legal traditions may offer slightly different definitions of contracts. English law, for example, does not have a formal definition of a contract. Any definition given by the English scholars thus tends to be only ‘provisional’ or ‘indicative’. For example, *Treitel on The Law of Contract* describes a contract as follows:

A contract is an agreement giving rise to obligations which are enforced or recognised by law. The factor which distinguishes contractual from other legal obligations is that they are based on the agreement of the contracting parties.¹

Other legal systems may offer a definition in their respective legislation. Article 1101 of the French Civil Code provides:

Le contrat est un accord de volontés entre deux ou plusieurs personnes destiné à créer, modifier, transmettre ou éteindre des obligations. (*A contract is an agreement between two or more persons to create, modify, transfer or extinguish obligations.*)

Some definitions may be found in non-binding treatises. On the other side of the Atlantic, Restatement (Second) of Contracts (USA) § 1, gives the following definition:

¹ Edwin Peel (ed), *Treitel on The Law of Contract* (14th edn, Sweet & Maxwell 2015).

A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.

Discussion:

- What is the difference between a ‘promise’ and a ‘contract’?
- How would you define a contract?

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2. Why Do We Need Contracts?

Making contracts is a social practice, but many agreements work without any law. They are often 'self-enforcing'. This can be for multiple reasons:

- Reputation: Parties do not breach agreements because they want to deal again.
- Mutual benefit: Both parties are interested in making the deal happen (e.g., I want the coffee, you want my €3).
- Instantaneous exchange: Handing over cash for goods immediately.

However, this may not be enough. Sometimes we need legally enforceable agreements for:

- Strangers: Dealing with someone you will never see again (low trust).
- Deferred exchanges: Part of the deal happens now, another later (high risk).
- High value: Buying a house or a company (social sanctions are not enough).
- Insurance: To know exactly what happens if things go wrong.

So, what is the function of contract law? Jill Poole offers a following analysis:

If the role of the device of contract is to provide for confident planning of exchanges, the role of contract law is to mould those planned exchanges to the particular society the law serves and to devise applicable principles which regulate the contractual relationship, e.g. deciding when a contract comes into existence, when it is broken, and the consequences of breach. Thus, inevitably English contract law reflects the politico-economic philosophy prevailing in this country and, interestingly, contract principles tend to reflect society's changing political context, e.g. changing attitudes to the prevalence of contractual certainty or flexibility.²

² Jill Poole, *Textbook on Contract Law* (11th edn, Oxford University Press 2012) 3.

Discussion:

- Think about a selected legal system. What philosophy does it reflect?
- If contract law truly reflects the unique 'politico-economic philosophy' of each society, is it possible to create a unified 'transnational contract law' (such as an European Civil Code)?

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3. Default Rules vs Mandatory Rules of Contract Law

Contract law is a mix of rules you can change and rules you must obey:

- Default rules: Apply unless they have been displaced by the terms of the contract.
- Mandatory rules: Apply in every situation, parties are not permitted to contract out.

Discussion: Imagine two parties write a contract. Decide if the law should allow them to write the following clauses:

- 'If the goods are defective, the buyer has NO right to complain or return them.'
- 'The price must be paid 10 days after delivery (instead of immediately).'
- 'The parties agree that they do not have to act in good faith.'
- 'Delivery will take place at the buyer's warehouse (instead of the seller's).'

- 'As the parties are B2B and there is no contractual imbalance, the seller is NOT liable for any damages caused by the machine, even if the damage is caused by the seller's intentional misconduct, fraud or gross negligence.'

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4. Some Key Principles

- Freedom of Contract (Party Autonomy):

The freedom to decide if, with whom, and on what terms to contract.

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- Sanctity of Contract (Pacta Sunt Servanda):

Once agreed, the contract is law between the parties. Promises should be kept.

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- **Market-Individualism:**

The purpose of a contract is to facilitate competitive exchange on the market. Judges should play a non-interventionist role.

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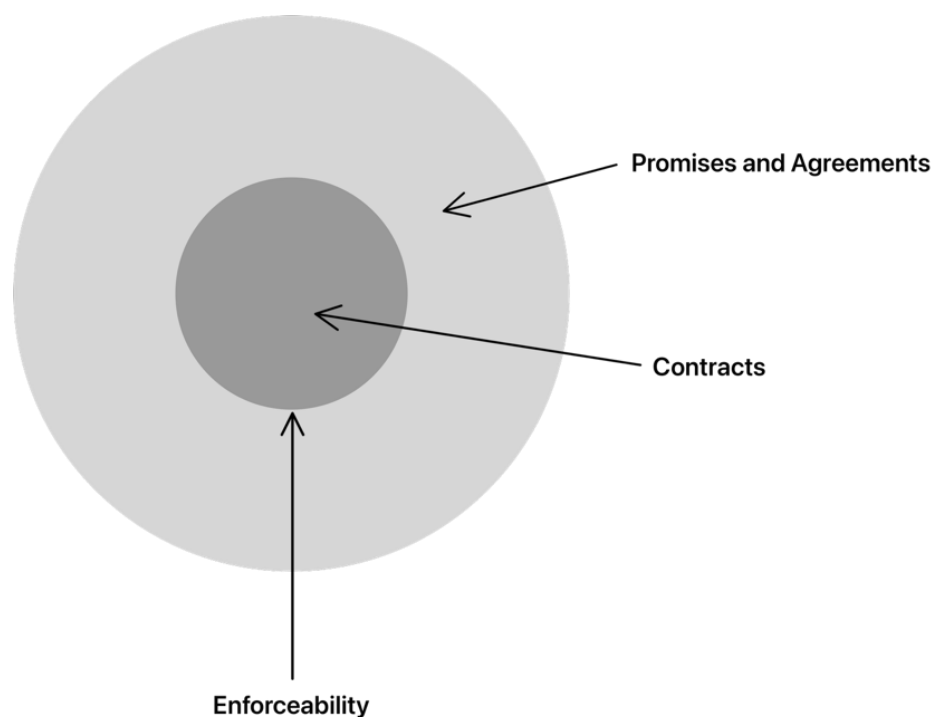
- **Weaker Party Welfarism:**

The modern (EU) approach: Contract law must protect the weaker party (usually the consumer) because of the power imbalance.

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PART 2: Unification of Contract Law, Europeanisation of Contract Law

Consider the following scenario:

Hans is a successful contractor based in Germany. After years of dominating the local market, Hans decides it is time to expand to other countries. He asks his in-house lawyer, Sophie, whether it is safe to expand his business to Slovakia and Italy. He is particularly curious what legal risks he should prepare for.

Sophie spends some time trying to search for laws. She is initially very happy as she confirms that the European Single Market allows Hans to move his employees abroad and sell goods without tariffs, just as easily as at home.

However, she struggles to figure out the contract law. When she tries to determine what a contract would require in Italy and in Slovakia, she realises that she is lost. The rules on how to form a contract, how to claim damages or when a penalty clause is valid seem to be different. While she is familiar with the German Civil Code, she knows nothing about the Italian and Slovak laws.

Discussion:

- How should Sophie answer Hans's question regarding the potential legal risks of expanding his German business to Slovakia and Italy?
- What options does Hans have to mitigate those risks? Which would be the best option?
- Is there a neutral compromise if Hans refuses to use Slovak law (too risky) and the Slovak partner refuse to use German law (unknown to them)?

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1. Unification of Contract Law

To solve problems arising out of differences between different legal systems, various initiatives have been launched to develop tools to bridge the gap between national laws. Generally, we can distinguish between two main approaches.

One option is **harmonising the rules of private international law**. This involves creating a uniform set of rules to deal with questions of jurisdiction, applicable law, and the recognition and enforcement of foreign judgments. This, in turn, facilitates cross-border trades because parties can predict more easily what law will apply to their contracts and which court will hear potential disputes. A great deal has been accomplished in this field, particularly in the area of civil and commercial matters. For example, across the EU, much of private international law is now harmonised through EU legislation (such as Rome I,³ Rome II⁴ and Brussels I Recast⁵ regulations). There are also significant international treaties, such as the Hague Choice of Court Convention.⁶

³ Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) [2008] OJ L177/6 ('Rome I').

⁴ Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II) [2007] OJ L199/40 ('Rome II').

⁵ Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast) [2012] OJ L351/1 ('Brussels I Recast').

⁶ Convention of 30 June 2005 on Choice of Court Agreements (adopted 30 June 2005, entered into force 1 October 2015) 44 ILM 1294 (2005) ('Hague Convention').

Harmonising private international law, however, only does part of the job. While it ensures that parties to a contract know *which* law will apply and which court will decide potential disputes, it does not solve the problem of not knowing what that law actually stipulates. A German party might know that Italian law applies, but they still face the burden of understanding the specific rules of the Italian law. For this reason, there is a rather strong push from some scholars and practitioners to **harmonise the substantive rules of private law itself**. Here, the most focus has been on contracts, but projects also exist for other areas of private law (such as tort law). The general idea is that a uniform set of contract law rules would make cross-border transactions and trade easier.

Discussion:

- In what ways would a uniform contract law make cross-border trade easier?
- What problems would it, on the other hand, NOT solve?

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1.1. The CISG

...the adoption of uniform rules which govern contracts for the international sale of goods and take into account the different social, economic and legal systems would contribute to the removal of legal barriers in international trade and promote the development of international trade...⁷

One of the most successful attempts to harmonise substantive contract law is the United Nations Convention on Contracts for the International Sale of Goods, commonly known as the CISG. The CISG is an example of hard law. This means it is not just a recommendation; it is binding law. Adopted in Vienna in 1980, it is an international treaty that has been ratified by over 90 countries. The list includes most EU member states, the USA or China. Crucially, the CISG applies automatically to contracts for the international sale of goods unless the parties explicitly agree to exclude it.

The scope of the CISG, however, is limited:

CISG, Article 1

(1) This Convention applies to contracts of sale of goods between parties whose places of business are in different States:

- (a) when the States are Contracting States; or
- (b) when the rules of private international law lead to the application of the law of a Contracting State.

There are additional limitations set forth in Articles 2 – 5. Article 6 also provides that the parties may exclude the application of the CISG.

⁷ Preamble to the United Nations Convention on Contracts for the International Sale of Goods (adopted 11 April 1980, entered into force 1 January 1988) 1489 UNTS 3 ('CISG').

1.2. The European Project

While the CISG is undoubtedly a major success for the global sale of goods, by focusing merely on the sale of goods it leaves a significant gap. To fill this gap, European scholars embarked on an ambitious project. These efforts have been driven by the push to create a more efficient EU Single Market.

One idea was to create a 'European Civil Code', a single piece of law that would replace national codes. However, due to political resistance and cultural differences, this project perhaps proved too ambitious and never happened. Instead, the unification efforts have led to multiple soft law instruments and academic projects. Unlike the CISG (which is a binding international treaty), soft law instruments are non-binding. They serve as 'model rules' or a source of inspiration for legislators and judges.

The most important results of the process of Europeanisation of contract law are:

- The PECL: The Principles of European Contract Law (our main focus).
- The DCFR: The Draft Common Frame of Reference. It includes PECL but adds torts, unjust enrichment and property law. It is more academic and complex.

Exercise:

Hans is expanding his business. Look at the following three contracts he enters into. Based on Article 1 CISG, decide if the CISG applies. If CISG does not apply to the contract, what law will likely apply to it?

- Contract 1: Hans buys 5 new cranes from France. Both Germany and France are CISG member states.

- Contract 2: Hans buys 10 new cranes from France. Both Germany and France are CISG member states. The contract he signs contains a clause 'The parties agree that the CISG Convention should not apply to this contract'.
- Contract 3: Hans signs a contract to build a hotel for a client in Italy. This involves mostly labour and engineering services. Both Germany and Italy are CISG member states.

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2. The PECL Project

The Principles of European Contract Law, or the PECL, were drafted by the Commission on European Contract Law, led by the Danish professor Ole Lando (the Commission was widely known to as the 'Lando Commission'). Its members, scholars and academics, have worked on a goal to find the 'common core' of all European legal systems and write down a set of model-rules of contract law across the EU. As it was an informal arrangement, the PECL can also be described as a 'non-legislative codification', or 'restatement' of contract law. The PECL were published in a span of multiple years: Part I of the PECL was published in 1995, Part II in 2002 and, finally, Part III in 2003.

What are the objectives of the PECL?

- Offering contractual parties a 'neutral' European set of rules.
- Formulation of general principles of contract law to be used, for example, by international arbitrators (*lex mercatoria*).
- Giving the EU legislator a set of model definitions to use when drafting new EU legislation.
- Serving as a source of inspiration for national legislators reforming their laws and for judges interpreting contracts.

The practical application of the PECL is a bit complicated. The PECL themselves define its application as follows:

PECL, Article 1:101: Application of the Principles

- (1) These Principles are intended to be applied as general rules of contract law in the European Communities.
- (2) These Principles will apply when the parties have agreed to incorporate them into their contract or that their contract is to be governed by them.
- (3) These Principles may be applied when the parties:
 - (a) have agreed that their contract is to be governed by "general principles of law", the "*lex mercatoria*" or the like; or
 - (b) have not chosen any system or rules of law to govern their contract.
- (4) These Principles may provide a solution to the issue raised where the system or rules of law applicable do not do so.

The complication lies in its soft law character. As the PECL are merely a model set of rules and not a law of a state, many systems of private international law might disallow their direct use in state courts. For example, the EU Rome I Regulation (which governs how EU national judges determine the law applicable to contracts) only

allows for a choice of a law of a State (e.g., Slovak Law, Austrian Law). Thus, under Rome I, the PECL cannot be chosen directly as the governing applicable law.

However, there are two main ways parties can still use them in practice:

- Incorporation into the Contract

Parties may wish to *incorporate* the PECL into their contract. That means using the PECL as a set of standard terms and conditions. The rules of the PECL are simply copied (or referenced) into the contract and bind the parties like any other contractual clause. However, the parties need to be aware that because they act merely as contract terms, the PECL will not override the mandatory rules of the national law that ultimately governs the contract.

- International Arbitration

The PECL may also be used by arbitrators, who have much more flexibility than national court judges. Unlike state courts bound by the Rome I Regulation, international arbitration tribunals are often permitted to decide disputes based on non-state 'rules of law', general principles or the *lex mercatoria*. If the contractual parties agree to resolve their disputes through arbitration and choose the PECL, the arbitrator will apply the PECL directly to solve the case, in principle bypassing national civil codes entirely.

3. The DCFR

The Draft Common Frame of Reference, or the DCFR (published in 2009), is in many ways similar to the PECL, but it goes much further.

In addition to contract law, it also includes other areas of private law, such as tort law, unjust enrichment, and trusts. It is a comprehensive academic text which hopes to set down the basic structure and serve as a source of inspiration for European institutions, should there one day be the political will to adopt a binding 'European Civil Code'.

Its practical success, however, has been rather limited. Because of its massive size and academic complexity, legal practitioners and arbitrators still generally prefer to use the older, more concise PECL when looking for general principles of contract law. For this reason, our course will focus primarily on the PECL rather than the DCFR.

4. Drafting Exercise

(A) You are drafting a contract between Company A (Netherlands) and Company B (Greece). Neither side wants to use the other's national law. They want a neutral European solution. Write a choice of law clause for the contract that incorporates the PECL into the contract.

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(B) Company A (Netherlands) and Company B (Greece) decide they absolutely refuse to have any national law govern their contract, even as a background fallback. They want their contract to be governed exclusively by the PECL. Based on what you learned about the flexibility of international dispute resolution, what mechanism should they choose? Write a short clause that refers future disputes to this mechanism and selects the PECL as the applicable rules of law.

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PART 3: Creating Binding Obligations – Formation of Contract

Consider the following scenario:

It is the late 19th century and England is plagued by an influenza epidemic. The Carbolic Smoke Ball Company produces and sells a device called a carbolic smoke ball. It is a rubber ball with a tube that is filled with powdered carbolic acid. The tube is meant to be inserted into the nose so that the powder will make the nose run, thereby making the nose clean. On November 13, 1891, the Carbolic Smoke Ball Company posts a following advertisement in newspapers:

100l. reward will be paid by the Carbolic Smoke Ball Company to any person who contracts the increasing epidemic influenza, colds, or any disease caused by taking cold, after having used the ball three times daily for two weeks according to the printed directions supplied with each ball. 1000l. is deposited with the Alliance Bank, Regent Street, shewing our sincerity in the matter.

During the last epidemic of influenza many thousand carbolic smoke balls were sold as preventives against this disease, and in no ascertained case was the disease contracted by those using the carbolic smoke ball.

One carbolic smoke ball will last a family several months, making it the cheapest remedy in the world at the price, 10s., post free. The ball can be refilled at a cost of 5s. Address, Carbolic Smoke Ball Company, 27, Princes Street, Hanover Square, London.

Mrs. Carlill saw this advertisement and bought one of the balls. She used it as advertised, three times a day, from November 20, 1891, to January 17, 1892, when she eventually fell sick with influenza. She is furious and demands that the Carbolic Smoke Ball Company pays her the promised cash reward.⁸

⁸ *Carlill v Carbolic Smoke Ball Co* [1893] 1 QB 256 (CA).

Discussion:

- Is there a legally binding contract between Mrs. Carlill and the Carbolic Smoke Ball Company?
- The Company claimed that the advertisement was *not* intended to be a promise at all: it was a mere puff, a marketing strategy, which meant nothing. Do you agree?
- The Company also argued that Mrs. Carlill only saw the advertisement but never notified them of her acceptance, therefore there could not be any contract concluded. Do you agree?

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1. General Requirements for a Contract

As we have seen so far, not all agreements and promises will constitute a legally binding contract. The line between a contract and a mere promise may be sometimes difficult to draw. In the case of *Mrs. Carlill*, English courts ultimately decided that the newspaper advertisement was an offer which could be accepted by anyone who performed the conditions set out in it. Mrs. Carlill did so, thereby entering into a contract with the Carbolic Smoke Ball Company.

We will now dive deeper into the rules of contract law, starting with contract creation.

The PECL provide the following requirements for the creation of a legally enforceable contract:

PECL, Article 2:101: Conditions for the Conclusion of a Contract

(1) A contract is concluded if:

- (a) the parties intend to be legally bound, and
- (b) they reach a sufficient agreement without any further requirement.

(2) A contract need not be concluded or evidenced in writing nor is it subject to any other requirement as to form. The contract may be proved by any means, including witnesses.

Let us break down these two essential pillars:

1.1. Intention to be Legally Bound

In contract law, when determining what a party to the contract intended, we usually do not focus on what the party thought, but rather on how their actions would be interpreted objectively:

PECL, Article 2:102: Intention

The intention of a party to be legally bound by contract is to be determined from the party's statements or conduct as they were reasonably understood by the other party.

1.2. Sufficient Agreement

Even if both parties want to be bound, they must actually agree on the essential terms of the contract. Such an agreement is typically reached through the process of offer and acceptance.

PECL, Article 2:103: Sufficient Agreement

- (1) There is sufficient agreement if the terms:
 - (a) have been sufficiently defined by the parties so that the contract can be enforced, or
 - (b) can be determined under these Principles.
- (2) However, if one of the parties refuses to conclude a contract unless the parties have agreed on some specific matter, there is no contract unless agreement on that matter has been reached.

1.3. No Form Required

Some legal systems require that certain contracts must be made in writing. Such an approach was rejected by the PECL. Article 2:101(2) stipulates that there are no formalities required for the conclusion of a contract. As long as the two essential conditions – intention to be legally bound and sufficient agreement – are fulfilled, a

contract is formed. Thus, '[e]ven an undertaking to lend money and a promise to receive a deposit are effective before they have been fulfilled.'⁹

2. Offer

Contracts typically start with one party (the offeror) giving a proposal (an offer) to another party (the offeree):

PECL, Article 2:201: Offer

- (1) A proposal amounts to an offer if:
 - (a) it is intended to result in a contract if the other party accepts it, and
 - (b) it contains sufficiently definite terms to form a contract.
- (2) An offer may be made to one or more specific persons or to the public.
- (3) A proposal to supply goods or services at stated prices made by a professional supplier in a public advertisement or a catalogue, or by a display of goods, is presumed to be an offer to sell or supply at that price until the stock of goods, or the supplier's capacity to supply the service, is exhausted.

It is important to distinguish between offers and mere invitations to make offers. For example, advertisements of a house to rent for a certain price will not be an offer which will become legally binding when accepted.¹⁰

An offer can typically be taken back by the offeror, but usually there are rules that restrict such a revocation:

⁹ Ole Lando and Hugh Beale (Eds), *Principles of European Contract Law: Parts I and II* (Kluwer Law International 2000) 138.

¹⁰ *ibid* 160.

PECL, Article 2:202: Revocation of an Offer

- (1) An offer may be revoked if the revocation reaches the offeree before it has dispatched its acceptance or, in cases of acceptance by conduct, before the contract has been concluded under Article 2:205(2) or (3).
- (2) An offer made to the public can be revoked by the same means as were used to make the offer.
- (3) However, a revocation of an offer is ineffective if:
 - (a) the offer indicates that it is irrevocable; or
 - (b) it states a fixed time for its acceptance; or
 - (c) it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer.

Finally, an offer can also be rejected by the offeree: 'When a rejection of an offer reaches the offeror, the offer lapses' (PECL, Article 2:203).

3. Acceptance

Once the other party (the offeree) becomes aware of the offer, they can choose to accept it. Under the PECL, no form is required for a valid acceptance:

PECL, Article 2:204: Acceptance

- (1) Any form of statement or conduct by the offeree is an acceptance if it indicates assent to the offer.
- (2) Silence or inactivity does not in itself amount to acceptance.

The following PECL provisions set down additional rules such as the time of conclusion of the contract (Article 2:205:), the time limit for acceptance (Article 2:206), late acceptance (Article 2:207), modified acceptance (Article 2:208), conflicting general conditions (Article 2:209) or written confirmation between professionals (Article 2:210).

It is worth pausing for a while to discuss the modified acceptance rule (PECL, Article 2:208). The general rule in contract law is that for acceptance to be valid, the offeree has to accept exactly the same terms of the offer. This is referred to as the *mirror image rule*, because a valid acceptance should reflect the offer like a mirror reflects an object. If the offeree's acceptance introduces new terms, it is not an acceptance but rather a counteroffer. This typically counts as a rejection of the original offer and sends the ball back to the original offeror who can choose to accept or reject the counteroffer.

However, the PECL introduce an exception that allows for the possible introduction of new terms into the acceptance, provided that those new terms do not materially alter the original offer:

PECL, Article 2:208: Modified Acceptance

- (1) A reply by the offeree which states or implies additional or different terms which would materially alter the terms of the offer is a rejection and a new offer.
- (2) A reply which gives a definite assent to an offer operates as an acceptance even if it states or implies additional or different terms, provided these do not materially alter the terms of the offer. The additional or different terms then become part of the contract.
- (3) However, such a reply will be treated as a rejection of the offer if:
 - (a) the offer expressly limits acceptance to the terms of the offer; or
 - (b) the offeror objects to the additional or different terms without delay; or
 - (c) the offeree makes its acceptance conditional upon the offeror's assent to the additional or different terms, and the assent does not reach the offeree within a reasonable time.

Lastly, keep in mind that PECL, Article 2:107 stipulates that '[a] promise which is intended to be legally binding without acceptance is binding' (Promises Binding without Acceptance). Moreover, if the process of conclusion of a contract cannot be

analysed into offer and acceptance, PECL, Article 2:211 provides that the provisions regarding offer and acceptance shall be applied with appropriate adaptations.

4. Communication of Offer and Acceptance

If we say that a contract is formed the moment the offer is accepted, the question then becomes how this applies to situations where communication happens via remote means. When is a contract created if the offer and acceptance happen via post? More recently, digital means of communication have brought new challenges to traditional rules of contract law. If the offeree sends an email accepting an offer, when exactly is the contract formed? Does it happen the second they click 'send', the moment the email actually arrives in the other party's inbox, or does it happen when the offeror reads the email containing the acceptance?

Different legal systems have historically had different answers to these questions. For postal situations, the traditional English common law operates with an exception called the 'Postal Rule',¹¹ under which acceptance through post is valid the moment a letter is dropped into a mailbox. Such a rule typically does not exist in continental legal systems. Following the continental tradition, under the PECL, any communication regarding a contract must *actually reach* the other party to have legal effect. This is referred to as the 'Receipt Principle'. Importantly, '[i]t is not necessary that the notice should actually have come to the addressee's attention provided that it has been delivered to him in the normal way, e.g. a letter placed in his letter box or a message sent to his telex or fax machine.'¹²

¹¹ See, for example, *Adams v Lindsell* (1818) 106 ER 250.

¹² Ole Lando and Hugh Beale (Eds), *Principles of European Contract Law: Parts I and II* (Kluwer Law International 2000) 129.

PECL, Article 1:303: Notice

- (1) Any notice may be given by any means, whether in writing or otherwise, appropriate to the circumstances.
- (2) Subject to paragraphs (4) and (5), any notice becomes effective when it reaches the addressee.
- (3) A notice reaches the addressee when it is delivered to it or to its place of business or mailing address, or, if it does not have a place of business or mailing address, to its habitual residence
- (4) If one party gives notice to the other because of the other's non-performance or because such non-performance is reasonably anticipated by the first party, and the notice is properly dispatched or given, a delay or inaccuracy in the transmission of the notice or its failure to arrive does not prevent it from having effect. The notice shall have effect from the time at which it would have arrived in normal circumstances.
- (5) A notice has no effect if a withdrawal of it reaches the addressee before or at the same time as the notice.
- (6) In this Article, 'notice' includes the communication of a promise, statement, offer, acceptance, demand, request or other declaration.

One of the most famous discussions of this issue was given by the English judge Lord Denning in *Entores Ltd v Miles Far East Corp* when dealing with modern, instantaneous forms of communication (such as telephone or telex):

Let me first consider a case where two people make a contract by word of mouth in the presence of one another. Suppose, for instance, that I shout an offer to a man across a river or a courtyard but I do not hear his reply because it is drowned by an aircraft flying overhead. There is no contract at that moment. If he wishes to make a contract, he must wait till the aircraft is gone and then shout

back his acceptance so that I can hear what he says. Not until I have his answer am I bound.¹³

Lord Denning then applied this same logic to technology:

Now take a case where two people make a contract by telephone. Suppose, for instance, that I make an offer to a man by telephone and, in the middle of his reply, the line goes 'dead' so that I do not hear his words of acceptance. There is no contract at that moment. The other man may not know the precise moment when the line failed. But he will know that the telephone conversation was abruptly broken off: because people usually say something to signify the end of the conversation. If he wishes to make a contract, he must therefore get through again so as to make sure that I heard. Suppose next, that the line does not go dead, but it is nevertheless so indistinct that I do not catch what he says and I ask him to repeat it. He then repeats it and I hear his acceptance. The contract is made, not on the first time when I do not hear, but only the second time when I do hear. If he does not repeat it, there is no contract. The contract is only complete when I have his answer accepting the offer.¹⁴

Thus, while the postal exemption remains in place under English contract law, the rules on instantaneous forms of communication are similar to the PECL.

Discussion: Consider the following scenarios. Is there a legally binding contract formed, and if so, at what exact moment was it formed?

- Claudia enters a store, sees a discounted denim jacket with a price tag of €30, takes it to the checkout counter, pays by card.
- Carlos attends an art auction. He bids €1,000 for a painting of a Dutch landscape. The auctioneer bangs his gavel to close the sale.

¹³ [1955] 2 QB 327, 332.

¹⁴ *ibid* 332-33.

- Chloe browses an online shopping platform, adds a pair of shoes to her digital cart, clicks 'Confirm and Pay'. Five minutes later, she receives an automated email stating, 'Thank you for your order, it is now being processed.'

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5. Problem Question

Helena is closing down her restaurant. On Saturday, she emails her friend Hermia, who owns a small café. The email states: 'Hermia, I am selling my custom-built Italian espresso machine for €5,000. It is a great price. Take a few days to think about it and let me know. You can pick it up on Monday. But you will not get a better deal.'

Hermia is thrilled. She immediately writes an email back saying she accepts. However, she fails to notice that due to her poor internet connection, the email was never actually sent. Believing they have a deal, Hermia decides to prepare everything for the new machine. On Sunday, she sells her own old espresso machine and posts on social media that the café will be closed until Wednesday while she installs the new machine.

On Monday, Hermia calls Helena to arrange the pickup, only to find out her acceptance email was never sent. Before Hermia can say 'I accept' on the phone, Helena says, 'Sorry Hermia, another buyer just offered me €7,000 for the machine. I cannot sell it to you. I am revoking my offer.'

- Is there a legally binding contract concluded between Helena and Hermia?

[illegible]

PART 4: Reading Contracts – Interpretation and Implied Terms

Consider the following scenario:

Frigaliment Importing Co. is a Swiss corporation. It contracted with a New York company, B.N.S. International Sales Corp., to purchase chicken. On May 2, 1957, B.N.S. confirmed the sale to Frigaliment of the following:

US Fresh Frozen Chicken, Grade A, Government Inspected, Eviscerated
2½-3 lbs. and 1½-2 lbs. each
all chicken individually wrapped in cryovac, packed in secured fiber cartons or wooden boxes,
suitable for export
75,000 lbs. 2½-3 lbs.....@\$33.00 25,000 lbs. 1½-2 lbs.....@\$36.50 per 100 lbs. FAS New
York
scheduled May 10, 1957 pursuant to instructions from Penson & Co., New York.

When the shipment arrived in Switzerland, Frigaliment found that the birds were not young chickens suitable for broiling and frying, but rather older birds, suitable only for stewing (making soup). Frigaliment is very unhappy about this. They think ‘chicken’ in the contract clearly meant a young chicken, suitable for broiling and frying. B.N.S. does not agree. For them, ‘chicken’ should mean any bird of that species that meets contract specifications on weight and quality, including the ‘stewing chicken’. After all, if Frigaliment wanted young broilers only, they should have specified it.¹⁵

Discussion:

- Which interpretation of the word ‘chicken’ should be preferred?
- Does Frigaliment have a valid claim for breach of contract against B.N.S.?

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¹⁵ *Frigaliment Importing Co. v. B.N.S. International Sales Corp.*, 190 FSupp 116 (1960).

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1. General Rules of Interpretation

When parties enter into a contract, they often assume that words have a single, obvious meaning. As the *Frigaliment* case shows, this rarely holds true. Words can be ambiguous and have multiple meanings, clauses clear enough on they own can contradict each other, and situations will occur which the parties simply did not think about and did not provide an explicit clause. When a dispute arises, how courts decide what the contract actually means?

PECL, Article 5:101: General Rules of Interpretation

- (1) A contract is to be interpreted according to the common intention of the parties even if this differs from the literal meaning of the words.
- (2) If it is established that one party intended the contract to have a particular meaning, and at the time of the conclusion of the contract the other party could not have been unaware of the first party's intention, the contract is to be interpreted in the way intended by the first party.
- (3) If an intention cannot be established according to (1) or (2), the contract is to be interpreted according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances.

The PECL combine the subjective and the objective method of interpretation. The first and second paragraphs are thus concerned with what the parties actually intended. Courts should ascertain the parties' *subjective* intentions and respect them when interpreting the contractual terms. Where these intentions cannot resolve the dispute (for example, each party clearly meant something else or the parties' intentions would go against clear and unambiguous terms of the contract), the third paragraph provides an *objective* test: What would reasonable persons of the same kind as the parties, in the same circumstances, understand the words to mean?

When interpreting contractual terms, courts will not just look at the provisions of the contract alone. The PECL provide a non-exhaustive set of circumstances that judges should take into account when interpreting what the parties meant or what a reasonable person would mean:

Article 5:102: Relevant Circumstances

In interpreting the contract, regard shall be had, in particular, to:

- (a) the circumstances in which it was concluded, including the preliminary negotiations;
- (b) the conduct of the parties, even subsequent to the conclusion of the contract;
- (c) the nature and purpose of the contract;
- (d) the interpretation which has already been given to similar clauses by the parties and the practices they have established between themselves;
- (e) the meaning commonly given to terms and expressions in the branch of activity concerned and the interpretation similar clauses may already have received ;
- (f) usages; and
- (g) good faith and fair dealing

Discussion: Consider the following scenario. How should the courts interpret this notice?

A tenant had a lease for an office building in London. The lease was for a term of 10 years, starting on 13 January 1992. It contained a ‘break clause’, which provided that ‘[t]he tenant may by serving not less than six months’ notice in writing on the landlord... such notice to expire on the third anniversary of the term commencement date determine this lease...’.

The market for rents had fallen, and the tenant decided to take advantage of this opportunity to leave early. Thus, the tenant served the following notice on the landlord: ‘Pursuant to clause 7(13) of the lease we as tenant hereby give notice to you to determine the lease on 12 January 1995.’

Unfortunately, the tenant made a mistake. The exact ‘third anniversary’ of the commencement date was in fact 13 January 1995, not 12 January. The landlord refused to accept the notice, claiming that because it contained the wrong date, it was legally ineffective and the tenant had to keep paying rent.¹⁶

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¹⁶ *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749 (HL).

2. Tools of Interpretation

In addition to general rules, there are certain specific rules and principles in contract law that might be used by judges.

2.1 Contra Proferentem Rule

In many business dealings, one party drafts the contract and presents it to the other party. The contra proferentem rule provides that a drafting party that creates an ambiguous clause should not be allowed to benefit from their own poor drafting:

PECL, Article 5:103: Contra Proferentem Rule

Where there is doubt about the meaning of a contract term not individually negotiated, an interpretation of the term against the party who supplied it is to be preferred.

2.2. Preference to Negotiated Terms

Sometimes, parties will use a standard form of a contract but negotiate some terms individually. If this happens, preference will be given to those individually negotiated terms:

PECL, Article 5:104: Preference to Negotiated Terms

Terms which have been individually negotiated take preference over those which are not.

2.3. Preference to the Contract as a Whole

A common mistake in reading contracts is cherry-picking one specific word or sentence and ignoring the rest of the document. Words get their meaning from their context and courts will take into consideration the contract as a whole:

PECL, Article 5:105: Reference to Contract as a Whole

Terms are to be interpreted in the light of the whole contract in which they appear.

2.4. Terms to be Given Effect

If a clause has two possible meanings, one making the clause workable and the other illegal or void, the court will choose the meaning that saves the contract:

PECL, Article 5:106: Terms to Be Given Effect

An interpretation which renders the terms of the contract lawful, or effective, is to be preferred to one which would not.

2.5. Linguistic Discrepancies

International contracts are often drafted in more languages. Often, the parties themselves stipulate in their contract which version will prevail in case of a discrepancy. If they fail to do so, the PECL provide a default solution:

PECL, Article 5:107: Linguistic Discrepancies

Where a contract is drawn up in two or more language versions none of which is stated to be authoritative, there is, in case of discrepancy between the versions, a preference for the interpretation according to the version in which the contract was originally drawn up.

3. Statements giving rise to Contractual Obligations

During the negotiation phase, parties say many things to convince the other party to sign. But what happens if this specific promise or assurance never makes it into the final written contract? Is it just a pre-contractual statement, a part of the negotiations, or is it a legally binding term of the contract?

PECL, Article 6:101: Statements giving rise to Contractual Obligations

(1) A statement made by one party before or when the contract is concluded is to be treated as giving rise to a contractual obligation if that is how the other party reasonably understood it in the circumstances, taking into account:

- (a) the apparent importance of the statement to the other party;
- (b) whether the party was making the statement in the course of business;
- and
- (c) the relative expertise of the parties.

(2) If one of the parties is a professional supplier who gives information about the quality or use of services or goods or other property when marketing or advertising them or otherwise before the contract for them is concluded, the statement is to be treated as giving rise to a contractual obligation unless it is shown that the other party knew or could not have been unaware that the statement was incorrect.

(3) Such information and other undertakings given by a person advertising or marketing services, goods or other property for the professional supplier, or by a person in earlier links of the business chain, are to be treated as giving rise to a contractual obligation on the part of the professional supplier unless it did not know and had no reason to know of the information or undertaking.

4. Implied Terms

No contract, no matter how long or detailed, can cover every single possible situation. What happens when a dispute arises over an issue that the contract simply does not mention? Courts have the power to 'read into' the contract certain terms that are missing. These are called implied terms.

PECL, Article 6:102: Implied Terms

In addition to the express terms, a contract may contain implied terms which stem from

- (a) the intention of the parties,
- (b) the nature and purpose of the contract, and
- (c) good faith and fair dealing.

Question: Consider the following scenario. Is there an implied term to the contract?

Macduff hires a company called FastClean to prepare his newly renovated office building before the opening day. They sign a short contract stating: 'FastClean agrees to deep-clean all 40 office rooms by Friday at 5:00 PM. Price: €1,000.'

On Friday, the rooms are indeed spotless. However, Macduff discovers that the cleaners have piled all the collected garbage bags and empty chemical bottles in a massive, smelly mountain right in the middle of the lobby.

When Macduff demands they take the trash out, the FastClean manager refuses, pointing at the contract: 'Read the paper, Macduff. We agreed to clean the 40 rooms and we did that perfectly. Nowhere in this contract does it say we have to carry your trash out of the building. If you want us to do that, it will cost an extra €200.'

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5. Discussion

In light of what you have learned, how do you think the *Frigaliment Importing Co. v. B.N.S. International Sales Corp* case would be decided under the PECL?

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

PART 5: Problems with Contracts – Vitiating Factors

Consider the following scenario:

Aprilia World Service BV is a company manufacturing motorcycles. They strike a deal with the Spice Girls, a well-known group of singers consisting of five members, nicknamed 'Scary Spice', 'Sporty Spice', 'Baby Spice', 'Ginger Spice' and 'Posh Spice'. Under the agreement, Aprilia BV will sponsor the group's world tour, in exchange for the Spice Girls participating in commercials and allowing Aprilia to design motor scooters that will be marketed under the Spice Girls brand. The agreement described the group as 'currently consisting of five members'. All five of them participated in a shooting for a commercial.

As the sponsorship started, however, one of the Spice Girls, 'Ginger Spice', announced that she was going to leave the group. She also announced that she had informed the other members of the group about her intention to leave quite some time ago. Aprilia is shocked: they attached a lot of importance to being able to use the images of the five Spice Girls in their marketing. They claim that they would not have entered into the agreement if they had known that one of the Spice Girls would leave the group. According to Aprilia, the group lied to them, and they want to terminate the contract.¹⁷

Discussion:

- Should Aprilia be allowed to avoid the contract they signed with the Spice Girls?
 - Did the group actually 'lie' if they never explicitly said 'none of us is leaving'?
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¹⁷ *Spice Girls Ltd v Aprilia World Service BV* [2002] EWCA Civ 15, [2002] EMLR 27.

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1. What does it mean to vitiate a contract?

So far, we have looked at how contracts are formed. We assumed that if the parties intend to be legally bound and they reach a sufficient agreement, a binding contract exists. This contract can then be enforced by one party against another. However, what happens if the consent of one of the parties was obtained through a lie, mistake or threat? In contract law, issues that spoil an otherwise validly formed contract are called *vitiating factors*.

It is important to pause for a while to note the difference between *nullity* and *voidability*. Nullity (a void contract) means that the agreement has no legal effect from the very beginning. It is 'dead on arrival', usually because it involves something illegal or contrary to public policy (such as a contract to commit a crime or sell illegal drugs). The law treats it as if it never happened, regardless of what the parties want, and courts will not enforce it. Voidability (a voidable contract), on the other hand, means the contract is valid and binding until the aggrieved party actively decides to cancel it. The innocent party usually has the power of choice. They can either accept the flawed contract and keep it alive, or they can use the vitiating factor to strike it down.

As regards the validity of a contract, Chapter 4 of the PECL provides a set of vitiating factors. These are grounds for voidability a party can rely on to avoid the contract. Avoiding a contract means it becomes void (treated as if it never existed), and the parties must return whatever they have received. Importantly, grounds of nullity, such as invalidity arising from illegality, immorality or lack of capacity, are excluded from Chapter 4.

Let us examine the specific rules for these vitiating factors under the PECL.

2. Mistake

Sometimes, parties enter into a contract without any bad intentions, but they are completely mistaken about a fundamental fact. However, the law does not allow people to escape contracts just because they made a bad deal. After all, that promises and agreements should be kept is one of the fundamental principles of contract law. To avoid a contract due to a mistake, the error must be fundamental and usually involves the other party in some way.

PECL, Article 4:103: Fundamental Mistake as to Facts or Law

(1) A party may avoid a contract for mistake of fact or law existing when the contract was concluded if:

- (a)(i) the mistake was caused by information given by the other party; or
- (ii) the other party knew or ought to have known of the mistake and it was contrary to good faith and fair dealing to leave the mistaken party in error; or
- (iii) the other party made the same mistake, and
- (b) the other party knew or ought to have known that the mistaken party, had it known the truth, would not have entered the contract or would have done so only on fundamentally different terms

(2) However a party may not avoid the contract if:

- (a) in the circumstances its mistake was inexcusable, or
- (b) the risk of the mistake was assumed, or in the circumstances should be borne, by it.

Importantly, for these provisions to be applied, a contract must have been existing in the first place. This means that in some situations, there may be a thin line between a non-existing contract (there was no sufficient agreement) and a voidable contract.

Discussion: Consider the following scenario. Can this contract be vitiated?

A buyer entered into a contract to buy cotton from a seller. The contract stated that the cotton would be delivered to Liverpool on a ship named *Peerless* arriving from Bombay. Neither party knew that there were actually *two* different ships named *Peerless* sailing from Bombay to Liverpool. The buyer meant the ship sailing in October, while the seller meant the ship sailing in December.¹⁸

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¹⁸ *Raffles v Wichelhaus* 159 ER 375.

The contract can still be saved, however, if the other party is willing to adapt.

PECL, Article 4:105: Adaptation of Contract

- (1) If a party is entitled to avoid the contract for mistake but the other party indicates that it is willing to perform, or actually does perform, the contract as it was understood by the party entitled to avoid it, the contract is to be treated as if it had been concluded as the that party understood it. The other party must indicate its willingness to perform, or render such performance, promptly after being informed of the manner in which the party entitled to avoid it understood the contract and before that party acts in reliance on any notice of avoidance.
- (2) After such indication or performance the right to avoid is lost and any earlier notice of avoidance is ineffective.
- (3) Where both parties have made the same mistake, the court may at the request of either party bring the contract into accordance with what might reasonably have been agreed had the mistake not occurred.

3. Fraud

Fraud goes beyond a simple mistake; it involves intentional deception from the other party. As we saw in the Spice Girls scenario, fraud does not need to be a direct, spoken lie. Conduct alone or keeping silent about a crucial fact when good faith requires you to disclose can also amount to fraud.

PECL, Article 4:107: Fraud

- (1) A party may avoid a contract when it has been led to conclude it by the other party's fraudulent representation, whether by words or conduct, or fraudulent non-disclosure of any information which in accordance with good faith and fair dealing it should have disclosed.

(2) A party's representation or non-disclosure is fraudulent if it was intended to deceive.

(3) In determining whether good faith and fair dealing required that a party disclose particular information, regard should be had to all the circumstances, including:

- (a) whether the party had special expertise;
- (b) the cost to it of acquiring the relevant information;
- (c) whether the other party could reasonably acquire the information for itself; and
- (d) the apparent importance of the information to the other party.

Discussion: Applying the rules on fraud under the PECL, do you think Spice Girls' representation was fraudulent?

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4. Threats

A contract must be entered into freely. It follows that if someone forces a party to sign an agreement under the threat of violence or blackmail, their consent is vitiated.

PECL, Article 4:108: Threats

A party may avoid a contract when it has been led to conclude it by the other party's imminent and serious threat of an act:

- (a) which is wrongful in itself, or
- (b) which it is wrongful to use as a means to obtain the conclusion of the contract,

unless in the circumstances the first party had a reasonable alternative.

5. Excessive Benefit or Unfair Advantage

What if there is no direct threat and no explicit lie, but one party is particularly vulnerable? The law protects parties who are exploited due to their inexperience, economic distress or ignorance by someone who takes an unfair advantage of that situation.

PECL, Article 4:109: Excessive Benefit or Unfair Advantage

(1) A party may avoid a contract if, at the time of the conclusion of the contract:

- (a) it was dependent on or had a relationship of trust with the other party, was in economic distress or had urgent needs, was improvident, ignorant, inexperienced or lacking in bargaining skill, and
- (b) the other party knew or ought to have known of this and, given the circumstances and purpose of the contract, took advantage of the first party's situation in a way which was grossly unfair or took an excessive benefit.

(2) Upon the request of the party entitled to avoidance, a court may if it is appropriate adapt the contract in order to bring it into accordance with what might have been agreed had the requirements of good faith and fair dealing been followed.

(3) A court may similarly adapt the contract upon the request of a party receiving notice of avoidance for excessive benefit or unfair advantage, provided that this party informs the party who gave the notice promptly after receiving it and before that party has acted in reliance on it.

6. Unfair Terms

Sometimes the problem is not how the overall contract was formed, but what is hidden inside the standard 'small print'. The PECL protect parties from one-sided, pre-printed terms that create an unfair imbalance between the parties.

Article 4:110: Unfair Terms not Individually Negotiated

(1) A party may avoid a term which has not been individually negotiated if, contrary to the requirements of good faith and fair dealing, it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of that party, taking into account the nature of the performance to be rendered under the contract, all the other terms of the contract and the circumstances at the time the contract was concluded.

(2) This Article does not apply to:

- (a) a term which defines the main subject matter of the contract, provided the term is in plain and intelligible language; or to
- (b) the adequacy in value of one party's obligations compared to the value of the obligations of the other party.

7. Illegality

As we noted before, the vitiating factors in Chapter 4 (like mistake or fraud) make a contract voidable. However, some contracts are perceived to be so inherently wrong that the law steps in and declares them completely ineffective from the very beginning. If a contract involves committing a crime, or severely violates public morals, neither party can enforce it. Courts will refuse to help them. These rules are found in Chapter 15 of the PECL.

PECL, Article 15:101: Contracts Contrary to Fundamental Principles

A contract is of no effect to the extent that it is contrary to principles recognised as fundamental in the laws of the Member States of the European Union.

PECL, Article 15:102: Contracts Infringing Mandatory Rules

(1) Where a contract infringes a mandatory rule of law applicable under Article 1:103 of these Principles, the effects of that infringement upon the contract are the effects, if any, expressly prescribed by that mandatory rule.

(2) Where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract, the contract may be declared to have full effect, to have some effect, to have no effect, or to be subject to modification.

(3) A decision reached under paragraph (2) must be an appropriate and proportional response to the infringement, having regard to all relevant circumstances, including:

- (a) the purpose of the rule which has been infringed;
- (b) the category of persons for whose protection the rule exists;
- (c) any sanction that may be imposed under the rule infringed;
- (d) the seriousness of the infringement;
- (e) whether the infringement was intentional; and

(f) the closeness of the relationship between the infringement and the contract.

8. Problem Question

Antonio is a car dealer who specialises in unique and vintage cars. One Monday, Antonio invites over his neighbour, Sebastian, for a few drinks. Antonio asks Sebastian if he would sell him his vintage sports car. Sebastian is hesitant. He tells Antonio that it is a rare model with huge sentimental value. When Sebastian firmly tries to refuse, Antonio threatens him, stating that he will spread vicious rumours to destroy Sebastian's reputation in the neighbourhood if he does not sell the car to him. In fear, Sebastian agrees to the sale and signs the contract.

A few days later, Antonio inspects his new purchase more closely. He notices that while the car is indeed valuable, some parts that look like originals were actually replaced with cheaper replicas, pushing the value of the car down.

On Friday, Gonzalo comes to Antonio's shop and sees the car. He inspects the car and excitedly says to Antonio: 'Great, everything looks completely original! I would like to buy this car. With this one, I will surely impress my father-in-law, who is a huge car geek.' Antonio smiles, hands him the contract and says absolutely nothing about the replica parts. Gonzalo buys the car for a premium price. A week later, Gonzalo's father-in-law inspects the car and immediately points out the replica parts. Gonzalo realises he made a terrible mistake.

- Advise Sebastian and Gonzalo. Can they avoid the contracts they concluded with Antonio?

[illegible]

PART 6: Executing Contracts – Performance and Change of Circumstances

Consider the following scenario:

In October 1956, a company named Tsakiroglou & Co. agreed to sell 300 tons of Sudanese peanuts to Noble Thorl, a German buyer. The contract stated that the goods were to be shipped from Sudan to Hamburg, Germany, during November or December of that year at a fixed price of £50 per ton. At the time, goods were usually transported via the Suez Canal, which was the fastest and cheapest naval route.

However, on November 2, 1956, a major geopolitical crisis erupted, and the Suez Canal was completely blocked to all shipping. It remained closed for months. Because the canal was blocked, the only way to deliver the cargo to Germany was to sail the ship all the way around the continent of Africa, around the Cape of Good Hope. This alternative route would take more than twice as long and would drastically increase the shipping costs for the seller.

Tsakiroglou & Co. refused to ship the goods. They argued that going all the way around Africa was so completely different and so much more expensive that, in their view, the contract had become 'impossible' to perform. The German buyers disagreed and sued them for a breach of contract.¹⁹

Discussion:

- Did the closure of the Suez Canal make the contract truly impossible to perform?

¹⁹ *Tsakiroglou & Co. Ltd v Noble Thorl GmbH* [1962] AC 93 (HL).

- If an unforeseeable event makes performance much more complicated for one party than was anticipated, should the law allow them to walk away from the contract?

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1. Introduction to Performance

After a contract is validly formed and interpreted, the parties must execute it. In contract law, the execution of contractual obligations is called *performance*. Usually, well-drafted commercial contracts explicitly state who must do what, when and where. But what happens if the parties forget to include these practical details? A missing date or place does not make the contract invalid. Instead, the PECL provide default rules to fill in the gaps. Let us break some of them down.

1.1. Place of Performance

What happens if the contract does not specify where the performance should take place, where should the goods be delivered, or where should the money be paid? The PECL set down a clear distinction between paying money and delivering goods or services.

PECL, Article 7:101: Place of Performance

- (1) If the place of performance of a contractual obligation is not fixed by or determinable from the contract it shall be:
 - (a) in the case of an obligation to pay money, the creditor's place of business at the time of the conclusion of the contract;
 - (b) in the case of an obligation other than to pay money, the obligor's place of business at the time of conclusion of the contract.
- (2) If a party has more than one place of business, the place of business for the purpose of the preceding paragraph is that which has the closest relationship to the contract, having regard to the circumstances known to or contemplated by the parties at the time of conclusion of the contract.
- (3) If a party does not have a place of business its habitual residence is to be treated as its place of business.

This means that, by default, money 'travels' to the person waiting to be paid (the creditor), while goods 'stay' with the seller (the obligor) and the buyer must come and pick them up, unless the parties agreed on a specific delivery method.

1.2. Time of Performance

When does a contract need to be performed? If the parties have not explicitly set a date or a specific timeframe for the performance, one party might keep delaying the

performance indefinitely. To prevent this, the law provides a safety net. If no date is set, performance must happen within a 'reasonable time'.

PECL, Article 7:102: Time of Performance

A party has to effect its performance:

- (a) if a time is fixed by or determinable from the contract, at that time;
- (b) if a period of time is fixed by or determinable from the contract, at any time within that period unless the circumstances of the case indicate that the other party is to choose the time;
- (c) in any other case, within a reasonable time after the conclusion of the contract.

1.3. Alternative Performance

What happens when a contract gives parties a choice of how to perform but does not specify who gets to make the final decision? For instance, imagine a catering contract stating that the dessert will be 'a chocolate cake or a cheesecake'. Who makes the final call? If the contract is silent, the PECL default rule gives the power of choice to the party who is supposed to provide the performance (in this case, the caterer). However, to prevent them from delaying the event by being indecisive, the PECL provide that if they wait too long to choose, the other party gets to decide.

PECL, Article 7:105: Alternative Performance

- (1) Where an obligation may be discharged by one of alternative performances, the choice belongs to the party who is to perform, unless the circumstances indicate otherwise.
- (2) If the party who is to make the choice fails to do so by the time required by the contract, then:

- (a) if the delay in choosing is fundamental, the right to choose passes to the other party;
- (b) if the delay is not fundamental, the other party may give a notice fixing an additional period of reasonable length in which the party to choose must do so. If the latter fails to do so, the right to choose passes to the other party.

1.4. Performance by a Third Person

In modern business transactions, companies rarely do everything themselves. Instead, they often rely on subcontractors, freelancers or third parties to perform some parts of the contract. However, what if one party objects to having someone else actually doing the work for the other party? The PECL generally allow third-party performance, unless the contract requires personal performance.

PECL, Article 7:106: Performance by a Third Person

- (1) Except where the contract requires personal performance the obligee cannot refuse performance by a third person if:
 - (a) the third person acts with the assent of the obligor; or
 - (b) the third person has a legitimate interest in performance and the obligor has failed to perform or it is clear that it will not perform at the time performance is due.
- (2) Performance by the third person in accordance with paragraph (1) discharges the obligor.

Discussion: Imagine you hire a world-famous portrait artist to paint a picture of your family for €10,000. On the day of the painting, the artist sends his talented university student to do the job instead. Under the PECL, can you legally refuse the student's performance?

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2. Change of Circumstances

We already know that modern contract law is based on the principles of freedom of contract and that agreements should be kept (*pacta sunt servanda*). These principles assume that when two parties enter into a contract together, they bear the normal commercial risks of their deal. But what happens if, after the contract was made, an unforeseeable event (such as a natural disaster, sudden war or global pandemic) changes the circumstances so radically that performance now requires one of the parties to do something quite different to what they agreed to do in the first place?

PECL, Article 6:111: Change of Circumstances

(1) A party is bound to fulfil its obligations even if performance has become more onerous, whether because the cost of performance has increased or because the value of the performance it receives has diminished.

(2) If, however, performance of the contract becomes excessively onerous because of a change of circumstances, the parties are bound to enter into negotiations with a view to adapting the contract or terminating it, provided that:

(a) the change of circumstances occurred after the time of conclusion of the contract,

(b) the possibility of a change of circumstances was not one which could reasonably have been taken into account at the time of conclusion of the contract, and

(c) the risk of the change of circumstances is not one which, according to the contract, the party affected should be required to bear.

(3) If the parties fail to reach agreement within a reasonable period, the court may:

(a) terminate the contract at a date and on terms to be determined by the court ; or

(b) adapt the contract in order to distribute between the parties in a just and equitable manner the losses and gains resulting from the change of circumstances.

In either case, the court may award damages for the loss suffered through a party refusing to negotiate or breaking off negotiations contrary to good faith and fair dealing.

Discussion: Jan, a construction contractor, signs an agreement to renovate an office building for €150,000. Two months into the project, due to market fluctuations and inflation, the cost of steel and cement increases by 15%. Jan realises his expected profit margin is completely wiped out. He worries he might even lose a little money on the job. He wants to force the client to renegotiate the contractual prices. Can he rely on Article 6:111 of the PECL?

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3. Frustration Doctrine

The PECL adopted a rather progressive approach to change of circumstances. To understand how flexible the PECL rules are, it is useful to stop for a while and look at the English law of contract which deals with changes of circumstances through the doctrine of *frustration*.

McKendrick describes the doctrine as follows:

A contract is frustrated where, after the contract was concluded, events occur which make performance of the contract impossible, illegal or something radically different from that which was in the contemplation of the parties at the time they entered into the contract.²⁰

However, this doctrine is very narrow in scope and English courts are reluctant to invoke it due to their notorious unwillingness to assist a party to simply escape a bad bargain. This can be demonstrated by two paradigm cases. In *Davis Contractors v Fareham UDC*, the claimants entered into a contract to build 78 houses for the defendants for the cost of £94,000. However, due to labour shortages, the work took much longer to complete and cost the builders £115,000. The claimants tried to rely on the frustration doctrine but their arguments failed to convince the court. As Lord Radcliffe explained,

[It is not] hardship or inconvenience or material loss itself which calls the principle of frustration into play. There must be as well such a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing from that contracted for.²¹

²⁰ Ewan McKendrick, *Contract Law* (16th edn, Bloomsbury UK 2025) 364.

²¹ [1956] AC 696 (HL) 729.

A similar result occurred in the case from our opening scenario, where sellers agreed to ship peanuts to European ports for a fixed price, expecting to use the Suez Canal. When the canal was closed, the only alternative was to send the goods around the Cape of Good Hope, massively increasing the transport costs. The English court held that this does not amount to frustration. The goods were not so perishable that they would not survive the longer journey around the Cape.²²

The approach adopted in the PECL steps away from this harsh ‘all-or-nothing’ approach and allows for adaptation and mandatory renegotiation if performance of the contract becomes ‘excessively onerous’.

4. Problem Question

CheapEnergy, an oil and gas company based in the Middle East, signs a two-year contract to supply ItalGas (an Italian distributor) with 100,000 barrels of liquified natural gas (LNG) every month at a fixed price of €60 per barrel. The standard shipping route for this gas is through the Strait of Hormuz, which is the only sea passage from the Persian Gulf to the rest of the world.

Six months into the contract, a severe regional conflict erupts. The Strait of Hormuz is heavily mined and completely blockaded by both regional and international military forces. Commercial shipping is paralysed.

CheapEnergy looks for alternatives. They find that they can still technically deliver the gas by pumping it through a newly built, privately owned land pipeline to the Red Sea, and then loading it onto ships there. However, the owner of the pipeline charges high transit fees. Using this alternative route

²² *Tsakiroglou & Co. Ltd v Noblee Thorl GmbH* [1962] AC 93 (HL).

would push CheapEnergy's total cost of delivery to €150 per barrel, meaning they will lose €10 million every single month they supply ItalGas.

CheapEnergy immediately sends a formal letter to ItalGas stating: ‘Due to the blockade, the agreement is frustrated and impossible to perform exactly as intended. We hereby terminate the agreement effective immediately.’

- Advise the parties on the appropriate next steps.

[illegible]

PART 7: When Contracts Go Wrong I – Non-Performance and Termination

Consider the following scenario:

Filario is completely renovating his house. He wants a custom-made kitchen from Imogena, who is a highly respected kitchen designer known for her unique designs. After they sign a contract for €20,000, Imogena takes the exact measurements of Filario's unusually shaped kitchen area. A few weeks later, Imogena receives a massive, highly profitable contract to decorate a luxurious apartment complex. She calls Filario and says, 'I am sorry, I am too busy now. I am cancelling our contract and returning your deposit.' Filario is furious. He does not want his money back, he wants Imogena to design and install his kitchen.

Filario also needs some seating for his new dining area. He buys six wooden chairs from a local furniture shop run by Jachimo for €600. The delivery is scheduled for Friday. On Thursday, Jachimo sends Filario a message: 'Our delivery van broke down and the chairs were damaged. I do not have more of them. I will be able to bring you new ones in 30 days.' Filario is annoyed. He does not want to wait for so long. He also finds out that there is a large store just five minutes away selling a similar model of chairs. He would prefer to buy those than wait for Jachimo.

- Should Filario be allowed to force Imogena to provide her services?
- Should Filario be allowed to escape the contract with Jachimo?

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1. Non-Performance

Despite the principle that agreements must be kept, contracts are broken every day. Everyone familiar with legal jargon has probably already heard the term ‘breach of contract’. A breach occurs if one of the parties fails to perform something that they agreed to in the contract or act contrary to its terms. The PECL does not use the word ‘breach’ and instead uses the broader and more neutral term ‘non-performance’.

PECL, Article 1:301(4) defines ‘non-performance’ as:

...any failure to perform an obligation under the contract, whether or not excused, and includes delayed performance, defective performance and failure to co-operate in order to give full effect to the contract.

When a non-performance occurs, the party who failed to keep their promise is called the *non-performing party*. The innocent person who suffered because of this failure is referred to as the *aggrieved party* (often also referred to as the injured party). Importantly, a failure to fulfil a contractual promise is considered a non-performance even if it is not the party’s fault. For example, in our opening scenario, Jachimo’s delivery van broke down. Although he did not break the contract on purpose, he still failed to deliver the chairs on Friday.

2. Introduction to Remedies

Once a contract has been breached, in other words, non-performed, it does not follow that the aggrieved party can simply walk away or automatically cancel the agreement. Instead, the law provides the aggrieved parties with a set of legal tools they can rely on. Importantly, not every non-performance automatically gives the other party the right to ask for every available remedy.

PECL, Article 8:101: Remedies Available

- (1) Whenever a party does not perform an obligation under the contract and the non-performance is not excused under Article 8:108, the aggrieved party may resort to any of the remedies set out in Chapter 9.
- (2) Where a party's non-performance is excused under Article 8:108, the aggrieved party may resort to any of the remedies set out in Chapter 9 except claiming performance and damages.
- (3) A party may not resort to any of the remedies set out in Chapter 9 to the extent that its own act caused the other party's non-performance.

The remedies set out in the Chapter 9 of the PECL include specific performance, withholding performance, termination, price reduction and damages.

3. Excused Non-Performance

What if the failure to perform is beyond the non-performing party's control? In previous part, we discussed the change of circumstances doctrine (where performance becomes excessively onerous). However, if an unforeseeable event makes performance completely impossible, the PECL provide a different rule. In such cases, the non-performance can be excused.

PECL, Article 8:108: Excuse Due to an Impediment

(1) A party's non-performance is excused if it proves that it is due to an impediment beyond its control and that it could not reasonably have been expected to take the impediment into account at the time of the conclusion of the contract, or to have avoided or overcome the impediment or its consequences.

(2) Where the impediment is only temporary the excuse provided by this article has effect for the period during which the impediment exists. However, if the delay amounts to a fundamental non-performance, the obligee may treat it as such.

(3) The non-performing party must ensure that notice of the impediment and of its effect on its ability to perform is received by the other party within a reasonable time after the non-performing party knew or ought to have known of these circumstances. The other party is entitled to damages for any loss resulting from the non-receipt of such notice.

Discussion: Consider the following scenario. Would Lucy's non-performance be excused under the PECL?

Laura orders a bespoke wedding cake from Lucy's Bakery for her wedding this coming Saturday. She pays a €200 deposit in advance. On Friday night, the main refrigerator in Lucy's bakery suddenly malfunctions and breaks down, completely melting all the cakes inside. Lucy is in such a panic trying to fix the fridge and save her other orders that she completely forgets to inform Laura about the situation.

Laura only finds out the bad news on Saturday morning when she arrives to pick up the cake. It is now too late to find a replacement and Laura has no cake for her wedding. Furious, Laura wants to sue Lucy for breach of contract and demand heavy financial compensation for ruining her big day.

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4. Specific Performance

If someone breaks a promise, the first instinct is usually to demand that they fulfil it. In contract law, a court order requiring the non-performing party to duly perform their contractual obligations is usually called an order of *specific performance*.

4.1. Monetary Obligations

A common case of non-performed obligation is simply a failure to pay. For example, if a party has already finished their part of the agreement and the other party fails to pay, the creditor has a right to demand the payment. But what happens if the performing party has started but not yet finished their work when the buyer suddenly wishes to cancel the contract? The PECL allow the creditor to nonetheless proceed with their performance and then recover any sum due. However, to prevent absurd economic waste, the principles set limits on this right.

PECL, Article 9:101: Monetary Obligations

- (1) The creditor is entitled to recover money which is due.
- (2) Where the creditor has not yet performed its obligation and it is clear that the debtor will be unwilling to receive performance, the creditor may nonetheless proceed with its performance and may recover any sum due under the contract unless:
 - (a) it could have made a reasonable substitute transaction without significant effort or expense; or
 - (b) performance would be unreasonable in the circumstances.

4.2. Non-Monetary Obligations

In other situations, the non-performed obligation does not involve paying money but constitutes a failure to perform a specific act or service. The aggrieved party may simply want the other party to honour their part of the deal. Under the PECL, a court may compel the non-performing party to fulfil their obligations. However, because such a mandated performance forces a party to act in a specific way, there are also limitations.

PECL, Article 9:102: Non-monetary Obligations

- (1) The aggrieved party is entitled to specific performance of an obligation other than one to pay money, including the remedying of a defective performance.
- (2) Specific performance cannot, however, be obtained where:
 - (a) performance would be unlawful or impossible; or
 - (b) performance would cause the obligor unreasonable effort or expense; or
 - (c) the performance consists in the provision of services or work of a personal character or depends upon a personal relationship, or
 - (d) the aggrieved party may reasonably obtain performance from another source.

(3) The aggrieved party will lose the right to specific performance if it fails to seek it within a reasonable time after it has or ought to have become aware of the non-performance.

4.3. Withholding Performance

Parties have a very practical self-help remedy they can try before going to court. They can refuse to fulfil their own contractual obligations until the other party fulfils theirs. This can be a useful tool because it puts commercial pressure on the non-performing party without actually terminating the contract.

PECL, Article 9:201: Right to Withhold Performance

(1) A party who is to perform simultaneously with or after the other party may withhold performance until the other has tendered performance or has performed. The first party may withhold the whole of its performance or a part of it as may be reasonable in the circumstances.

(2) A party may similarly withhold performance for as long as it is clear that there will be a non-performance by the other party when the other party's performance becomes due.

5. Termination

Sometimes, forcing the other party to perform is no longer desirable. If everything goes wrong with the contract, the aggrieved party might simply want to cancel it, recover their money and walk away. This is called termination. Termination is usually the measure of last resort of contract law. It completely destroys the agreement. Therefore, the law usually does not allow you to terminate a contract immediately for just any minor mistake. The breach must be fundamental.

PECL, Article 9:301: Right to Terminate the Contract

- (1) A party may terminate the contract if the other party's non-performance is fundamental.
- (2) In the case of delay the aggrieved party may also terminate the contract under Article 8:106 (3).

PECL, Article 8:103: Fundamental Non-Performance

A non-performance of an obligation is fundamental to the contract if:

- (a) strict compliance with the obligation is of the essence of the contract; or
- (b) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract, unless the other party did not foresee and could not reasonably have foreseen that result; or
- (c) the non-performance is intentional and gives the aggrieved party reason to believe that it cannot rely on the other party's future performance.

5.1. Additional Period

For instances where the non-performance constitutes a delay, the PECL provide a set of specific rules. A delay of a few days is inconvenient but usually does not lead to an immediate termination (this will depend on whether the delay is considered fundamental). Instead, the PECL adopt a practical legal mechanism, whereby a party can give the failing party an official 'last chance' deadline. If this new deadline is missed, the aggrieved party gets to terminate the contract.

PECL, Article 8:106: Notice Fixing Additional Period for Performance

- (1) In any case of non-performance the aggrieved party may by notice to the other party allow an additional period of time for performance.
- (2) During the additional period the aggrieved party may withhold performance of its own reciprocal obligations and may claim damages, but it

may not resort to any other remedy. If it receives notice from the other party that the latter will not perform within that period, or if upon expiry of that period due performance has not been made, the aggrieved party may resort to any of the remedies that may be available under chapter 9.

(3) If in a case of delay in performance which is not fundamental the aggrieved party has given a notice fixing an additional period of time of reasonable length, it may terminate the contract at the end of the period of notice. The aggrieved party may in its notice provide that if the other party does not perform within the period fixed by the notice the contract shall terminate automatically. If the period stated is too short, the aggrieved party may terminate, or, as the case may be, the contract shall terminate automatically, only after a reasonable period from the time of the notice.

5.2. Partial Termination

Contracts may involve multiple obligations over time. What happens if the non-performance only relates to one of those obligations? It does not follow that the whole contract needs to be terminated. If a contract can be logically divided into separate parts, the PECL allow for terminating only the problematic part and keeping the rest of the contract alive.

PECL, Article 9:302: Contract to be Performed in Parts

If the contract is to be performed in separate parts and in relation to a part to which a counter-performance can be apportioned, there is a fundamental non-performance, the aggrieved party may exercise its right to terminate under this Section in relation to the part concerned. It may terminate the contract as a whole only if the non-performance is fundamental to the contract as a whole.

6. Problem Question

David is a wealthy art collector. He concludes a contract with a famous sculptor, Rafaelo. Rafaelo is to carve a unique marble statue for David's private gallery. In return, David agrees to pay €5,000. He also agrees to allow Rafaelo exclusive access to his private gallery this upcoming weekend to host an exhibition of Rafaelo's other artworks.

A few days before the exhibition weekend, Rafaelo calls David and says: 'I have changed my mind. I am an artist and I no longer feel inspired to carve your statue. I am cancelling that part of our contract.' Rafaelo then adds: 'But I still expect you to open the gallery for me this weekend for my private exhibition. Just like we agreed.' David is furious. He wants the court to force Rafaelo to finish the statue. Furthermore, he completely refuses to open the gallery for Rafaelo this weekend.

- Advise David.

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PART 8: When Contracts Go Wrong II – Damages

Consider the following scenario:

After years of saving money, Hermione is finally building a new house for her family. In January, she signs a contract with Emilia's construction company, Cozy Housing, to build the house for €500,000. Hermione tells Emilia she wants the house to be built using specific 'Autumn Gold' coloured bricks. She also requires the house to be finished by the end of December.

Unfortunately, there are severe delays on Emilia's side, resulting in the construction not being finished in December. Hermione is deeply unhappy because she had already sold and moved out from her old apartment. Because she has nowhere to live, she rents a temporary flat for two months, costing her €4,000. When the house is finally completed in February, Hermione is shocked to find that the exterior walls were built using 'Summer Orange' bricks instead of 'Autumn Gold'. She absolutely hates the colour. Emilia tells her that despite the different colour, the house is structurally perfect, and its real estate market value is exactly the same as if the correct bricks had been used.

Hermione refuses to accept this. She wants Emilia to completely demolish the exterior walls and rebuild them with the correct 'Autumn Gold' bricks. This would cost additional €200,000. Hermione decides to sue Cozy Housing for both €4,000 for temporary rent and the €200,000 required to rebuild the walls.

- Do you think Hermione should be entitled to claim such damages for Cozy Housing's non-performance?

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1. Right to Damages

We already know that once a contract is non-performed, the law provides the aggrieved party with a set of legal tools they can rely on. One of the most important remedies is the opportunity for the aggrieved party to claim money in compensation for the non-performance. Such a compensation is in contract law called *damages*.

Chapter 9 of the PECL contains a wide variety of financial remedies. For instance, if a party is late to pay an invoice, the provisions of PECL grant the aggrieved party interest on the delayed payment (PECL, Article 9:508). There are also specific rules for calculating current market prices if the aggrieved party does not make a substitute transaction (PECL, Article 9:507), or rules reducing the damages if aggrieved party partially caused the loss themselves (PECL, Article 9:504). To understand the core mechanics of how contract law damages work, we will focus only on the most fundamental principles. The general rule is that the law aims to put the aggrieved party in the exact same financial position they would have been in if the contract had been perfectly performed. This includes actual financial losses, lost profits and even non-pecuniary loss (such as emotional distress).

PECL, Article 9:501: Right to Damages

- (1) The aggrieved party is entitled to damages for loss caused by the other party's non-performance which is not excused under Article 8:108.
- (2) The loss for which damages are recoverable includes:
 - (a) non-pecuniary loss; and
 - (b) future loss which is reasonably likely to occur.

PECL, Article 9:502: General Measure of Damages

The general measure of damages is such sum as will put the aggrieved party as nearly as possible into the position in which it would have been if the contract had been duly performed. Such damages cover the loss which the aggrieved party has suffered and the gain of which it has been deprived.

2. Foreseeability

However, putting the aggrieved party as nearly as possible into the position in which it would have been if the contract had been duly performed does not mean that all damages are recoverable. The law usually puts certain limits on the extent of liability to prevent the non-performing party from bearing infinite or unpredictable financial burdens. In the PECL, the most important restriction on the recovery of damages is that the loss should have been foreseeable at the time the contract was concluded.

PECL, Article 9:503: Foreseeability

The non-performing party is liable only for loss which it foresaw or could reasonably have foreseen at the time of conclusion of the contract as a likely result of its non-performance, unless the non-performance was intentional or grossly negligent.

3. Reduction of Loss

Another limit is the aggrieved party's duty to mitigate the damage, if possible. This duty requires the aggrieved party to take proactive and reasonable measures to minimise the financial impact of the non-performance. Thus, the aggrieved party cannot simply wait and allow losses to accumulate and then try to recover them.

PECL, Article 9:505: Reduction of Loss

- (1) The non-performing party is not liable for loss suffered by the aggrieved party to the extent that the aggrieved party could have reduced the loss by taking reasonable steps.
- (2) The aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the loss.

4. Substitute Transaction

In practice, a standard method of mitigating a loss when a party fails to deliver goods or services is to obtain them from an alternative source. If the aggrieved party lawfully terminates the contract and obtains the performance elsewhere, they are entitled to claim the difference between the original contract price and the cost of this substitute transaction.

Article 9:506: Substitute Transaction

Where the aggrieved party has terminated the contract and has made a substitute transaction within a reasonable time and in a reasonable manner, it may recover the difference between the contract price and the price of the substitute transaction as well as damages for any further loss so far as these are recoverable under this Section.

5. Penalty Clauses

Proving the exact extent of a financial loss can be difficult. This is why commercial contracts often contain pre-agreed payment provisions, commonly referred to as penalty clauses or liquidated damages. These clauses stipulate a predetermined sum to be paid in the event of non-performance. While the PECL enforce such agreements, they also allow courts to intervene and reduce the specified sum if it is grossly excessive to the actual loss sustained.

PECL, Article 9:509: Agreed Payment for Non-performance

- (1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of its actual loss.
- (2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances.

6. Reducing Price

In some cases of defective or non-conforming performance, the aggrieved party may still prefer to retain the goods or services rather than terminating the agreement and obtaining performance elsewhere. In such instances, the PECL provide an alternative remedy to claiming damages: the right to proportionately reduce the original contract price to reflect the diminished value of the performance received.

PECL, Article 9:401: Right to Reduce Price

- (1) A party who accepts a tender of performance not conforming to the contract may reduce the price. This reduction shall be proportionate to the decrease in

the value of the performance at the time this was tendered compared to the value which a conforming tender would have had at that time.

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7. Problem Question

The Highway is a highly successful pop band consisting of five members, with a total of 20 million followers across various social media platforms. They enter into a contract with a renowned music producer, Selena, to record a new album for €100,000. Prior to signing the agreement, one of the band members, Zohran, decides to leave the band by the end of the year. Knowing that Selena considers Zohran the lead talent and fearing she might cancel the agreement, the remaining members decide to hide this information from Selena and sign the contract without mentioning Zohran's upcoming departure.

On the first day of recording, Zohran is absent. Selena refuses to produce the album without the missing member. She immediately terminates the contract. As a result, Selena loses a €500,000 secret side-deal with a global cosmetics brand that intended to use the new album for their campaign. Selena promised the cosmetics brand that they could make five different products, each representing a member of The Highway. The band had absolutely no knowledge of this secret deal.

Furthermore, Selena invokes a specific provision in their recording contract which states: 'In the event the band fails to deliver the album for any fault of their own, they shall be liable to pay a penalty of €120,000.'

- Advise The Highway. Assess their potential liability for damages.

PART 9: Good Faith

Consider the following scenario:

Alice is a contractor specialising in custom home repairs. She is approached by John, who wants to know if Alice can undertake a major reconstruction of his flat. They spend several weeks negotiating a contract under which Alice will renovate the flat according to John's highly unorthodox specifications. On Friday, they finally agree on the price. They schedule a meeting for Tuesday to resolve a few minor outstanding details and officially sign the paperwork.

On Monday, Alice is approached by another potential client, Peter. He offers Alice a €10,000 contract to renovate a kitchen. Because Alice knows that she will not have the capacity to do both jobs and is certain that the major deal with John is secured, she rejects Peter's offer.

On Tuesday, John does not show up. It turns out that he never had any intention of signing a contract with Alice in the first place. He only engaged in the lengthy negotiations to find out Alice's pricing strategies because he is planning to start his own home repair business. Alice tries to contact Peter to accept the €10,000 kitchen job instead, but it is too late. Peter has already hired someone else.

- Should Alice be able to recover the €10,000 lost from John?

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1. Good Faith

Throughout this workbook, we have often encountered good faith in different rules and provisions of PECL. Indeed, good faith is a particularly important principle of European Contract Law.

PECL, Article 1:201: Good Faith and Fair Dealing

- (1) Each party must act in accordance with good faith and fair dealing.
- (2) The parties may not exclude or limit this duty.

Article 1:202: Duty to Co-operate

Each party owes to the other a duty to co-operate in order to give full effect to the contract.

We have seen that the PECL rely on good faith and fair dealing when determining what circumstances should be taken into account when interpreting contracts (PECL, Article 5:102) or what terms may be implied into the contract (PECL, Article 6:102). Good faith and fair dealing also play an important role when a party wants to avoid a contract due to a mistake (PECL, Article 4:103), fraud (PECL, Article 4:107), excessive benefit and unfair advantage (PECL, Article 4:109), or wants to avoid a contractual term that was not individually negotiated (PECL, Article 4:110). Nevertheless, good faith and fair dealing should not be understood as confined to those specific provisions. Instead, the concept of good faith and fair dealing represent a general idea that underpins the entire European Contract Law. 'It supplements the provisions of the [PECL], and it may take precedence over other provisions of [the PECL] when a strict adherence to them would lead to a manifestly unjust result.'²³

²³ Ole Lando and Hugh Beale (Eds), *Principles of European Contract Law: Parts I and II* (Kluwer Law International 2000) 113.

According to the authors of the PECL, the concept of good faith is a *subjective* test, meaning ‘honesty and fairness in mind’. On the other hand, the concept of fair dealing is *objective*, meaning ‘observance of fairness’.²⁴

2. Negotiations Contrary to Good Faith

A particularly important provision of the PECL imposes an obligation relating to pre-contractual obligations. While the principles understand that commercial parties need to have the freedom to negotiate, they also set a limit to this freedom to negotiate. If a party conducts the negotiations in bad faith, they may incur liability to the other party.

PECL, Article 2:301: Negotiations Contrary to Good Faith

- (1) A party is free to negotiate and is not liable for failure to reach an agreement.
- (2) However, a party who has negotiated or broken off negotiations contrary to good faith and fair dealing is liable for the losses caused to the other party.
- (3) It is contrary to good faith and fair dealing, in particular, for a party to enter into or continue negotiations with no real intention of reaching an agreement with the other party.

3. English Law Perspective

As the authors of the PECL noted, good faith and fair dealing seem to play a role in all European contract law systems. However, they differ as to the width of its scope. For example, while in German contract law the principle of good faith has played a major role, its importance in English law is much smaller.²⁵

²⁴ *ibid* 115-16.

²⁵ *ibid* 116.

The starting point is that English law has traditionally viewed the principle of good faith with scepticism. For example, in *Walford v Miles*, the judge held that ‘...the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations.’²⁶

However, that does not mean that there is no role for good faith in English law. In *Yam Seng Pte Ltd v International Trade Corp Ltd*, accepting that ‘references to good faith have already entered into English law’, the good faith principle was imposed as a contractual term implied by facts. But the Court did not accept that the good faith rule is automatically implied in all commercial contracts, holding that the English law is not ready for it yet.²⁷

One of the more recent Supreme Court of the United Kingdom’s decision summarises the positions as follows:

...English law has never recognised a general principle of good faith in contracting. Instead, English law has relied on piecemeal solutions in response to demonstrated problems of unfairness.²⁸

4. Essay Exercise

Task: Critically analyse the advantages and disadvantages of imposing a general obligation to act in good faith in contract law. Compare the approach taken by the PECL with the English law perspective. What is the role of party autonomy in each approach? Discuss how the law should approach the balance between commercial certainty and fairness.

²⁶ *Walford v Miles* [1992] 2 AC 128 (HL) 138.

²⁷ *Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111 (QB), [2013] 1 CLC 662 [124]-[131].

²⁸ *Pakistan International Airline Corp v Times Travel (UK) Ltd* [2021] UKSC 40, [2023] AC 101 [27].

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PART 10: Revision Problem Questions

1. The Tempest

Bertram is organising an outdoor party to celebrate his 30th birthday. He wants everything to be perfect. On Monday, he emails Diana, a local party equipment supplier: 'I offer to rent your biggest tent for July 10th for €1,500. I am planning an elegant and minimalist outdoor party. Furthermore, I agree to exclusively buy all my party drinks from your company, provided you give me a 20% discount on them.'

On Tuesday, Diana replies: 'I accept your offer for the tent and the drinks discount. However, please note that the biggest tent comes with four large, highly visible neon pink "Diana's Company" promotional banners attached to the outside walls, which cannot be removed. Please also note that there is a penalty of €15,000 if you cancel the event less than a week in advance.' Bertram reads the email but does not reply.

Two days before the party, Bertram discovers a major problem. Diana's biggest tent is made of cheap fabric and is not waterproof at all. Diana knew perfectly well that Bertram was holding an outdoor garden party. However, she kept quiet about the fabric because she wanted to secure the highly profitable deal and was afraid that Bertram would not rent a tent that is not waterproof.

Before Bertram can even complain to Diana about the fabric, a massive, unforeseeable storm hits the area. Consequently, Bertram is forced to cancel the party due to safety fears. The next day, Diana contacts Bertram and demands money. Bertram refuses to pay the €15,000 penalty and wants to escape the contract entirely.

Advise Bertram on the following points:

- Was a legally binding contract formed between Bertram and Diana?

- Assuming a contract was formed, could Bertram avoid it due to the tent not being waterproof?
- Assuming the contract is valid, do the severe weather conditions change Bertram's obligation to perform?
- Assuming Bertram is obliged to perform, will the court enforce the €15,000 penalty clause?

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2. The Illyrian Expedition

Viola is a marine biologist planning a research expedition to map a treacherous area of the sea known as the Illyrian Trench. She contacts Captain Belch, who is a wealthy businessman who runs a ship charter company. They sign a contract to rent a ship for €50,000. In the contract, Captain Belch agrees to provide either one of his two biggest ships, The Duke of Illyria or The Aguecheek.

Departure is scheduled for May 15th. Viola needs to know which ship will be used by May 10th at the latest so she can configure her equipment according to the ship's parameters. However, the contract does not explicitly state who has the right to choose the vessel.

By May 11th, despite Viola's repeated queries, Captain Belch has not informed her which ship he intends to use. On May 12th, Viola sends him an email: 'This is taking too long. You have 24 hours to pick a ship, or I will make the choice myself.' Captain Belch ignores the email. On May 13th, Viola emails him again: 'Time is up. I choose The Duke of Illyria.' She programmes her equipment according to the parameters of The Duke of Illyria. On May 15th, Viola arrives at the port. Captain Belch is there with The Aguecheek. He tells Viola: 'I am the owner, I provide the performance, so I get to choose the ship. You will take The Aguecheek.'

To Viola's shock, Captain Belch also informs her that he will not be navigating the ship himself. Instead, he hired Captain Andrew, a freelance captain. Viola, however, refuses to sail with Captain Andrew. She says that navigating the Illyrian Trench requires Captain Belch's specific expertise, which was the entire reason she hired his company. She tells Captain Belch that he will either navigate the ship himself or she will terminate the contract due to his multiple breaches.

Advise Viola on the following points:

- Who had the legal right to choose which ship will be used?
- Was Viola legally entitled to refuse performance by another captain?
- What remedies might be potentially available to Viola?

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3. The Ardennes Funds

Jaques wants to invest his life savings to secure his retirement. He contacts Audrey, a financial advisor who operates an investment scheme called *Ardennes Funds*. Under this scheme, the client's initial investment is paid into a fund, which is then actively traded on the foreign exchange market by an independent contractor named Oliver. The idea is to maximise the amount of the investment based on the fluctuation in exchange rates over the years.

Audrey presents Jaques with a standard-form contract. Before signing, Jaques points to a specific clause that reads: 'Ardennes Funds guarantees the use of a Safe Harbour Strategy to shield the client's capital.' Jaques does not understand this, so he asks Audrey: 'Does this mean my initial investment is 100% protected and I cannot lose a single euro under any circumstances?' Audrey smiles and replies: 'Exactly. That is what our Safe Harbour Strategy is for.' Relieved, Jaques signs the contract.

Five years later, the fund unexpectedly collapses. Oliver follows standard financial industry practices and manages to save 85% of Jaques's portfolio. However, 15% of the money is permanently lost. Jaques is furious. He wants to sue Audrey for breach of contract and demands that she repays the lost 15%. Audrey refuses, arguing that in the financial sector, 'Safe Harbour' is a well-known term for risk mitigation, not an absolute 100% guarantee against all losses. Jaques believes that if this is the case, then Audrey defrauded him. Furthermore, Jaques decides to sue Oliver directly for breach of contract, since Oliver was the one who actually executed the losing trades.

Advise Jaques on the following points:

- Can Jaques argue that he was defrauded by Audrey?
- How should the 'Safe Harbour' clause be interpreted?
- Does Jaques have a claim against Oliver for non-performance?

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