Chapter 3
Negotiation of international contracts

3.1. Contract formation

As explained in Chapter 1, contracts are legally binding and enforceable agreement creating mutual obligations between two or more parties.[1] They are used in a wide range of transactions, from everyday purchases to the most complex business operations. A huge variety of contractual types has been developed in the business practice, and even within each contractual type there could be very different levels of complexity.

The concept of graduated complexity of a contractual type can be illustrated as a "stairway" leading from the most basic agreements up to those regulating highly sophisticated business transactions.

The first step of such a stairway may be represented by a common **contract of sale**: a simple exchange whereby ownership of an item is transferred immediately from one party to the other as a result of the payment of a price. In daily life, the terms of such a contract (*e.g.* price, quantity, quality of goods) are usually pre-determined and the parties can immediately and simultaneously proceed with their respective performances. The level of complexity of a contract of sale will increase if some of its elements deviate from the standard, for instance if payment of the price is deferred; it will also increase when the contract regulates a transaction between parties that are not physically present at its making, and particularly when the parties (or goods) involved are situated in different countries.

Ascending the stairs, we may find a contract of supply, that is, an agreement between a seller (supplier) and a buyer (purchaser) for the provision of certain goods over a certain period of time. This is more complicated than a basic sale, as the contractual relationship between the parties does not cease with a single exchange of goods for money. Indeed, a contract of supply is characterised by the repetition of performances over a determinate period of time: goods are supplied on a regular basis, according to a scheme agreed by the parties. Contrary to the case of a simple contract of sale, the parties will be expected to agree on several more aspects of their dealings, for instance on the consequences of an unjustified delay in provision or in payment.

[1] Under the Italian Civil Code (art. 1321), a contract is defined as an "*agreement between two or more parties intending to establish, regulate or extinguish an economic relationship*". In the context of international trade, a basic principle is the "Freedom of contract", according to which "*[t]he parties are free to enter into a contract and to determine its content*". (clause 1.1 of UNIDROIT Principles 2016).

As a third step we may find, for example, a manufacturing & supply contract. In the same manner as under a supply contract, goods are provided in instalments within a determinate timeframe. The distinguishing feature of this type of contract lies in the fact that the purchaser has an active role in determining the nature and quality of the goods that he or she wishes to receive periodically against payment of the price. More precisely, the purchaser desiring a custom-made product needs to provide the manufacturer with precise production information on such product: it means that the contract will contain not only clauses typical of supply contracts, but also new clauses regulating, for instance, the extent and limits of transfer of intellectual property rights (industrial know-how, but also trademarks etc.) as needed in a given transaction.

The climb up this contractual stairway could continue to the most complicated structures for large cross-border corporate deals, but here our sole interest is to point out that the more complex the envisaged commercial operation is, the more time and resources the parties will need to spend in order to reach a viable agreement and execute their contract.

Given the great variety of contractual types, there is no formula that applies to every situation: the determining of a contract's contents is wholly dependent on the type of transaction that the parties contemplate.

Obviously, the degree of complexity of the commercial operation undertaken by the parties will have an impact on the length and complexity of the process leading to the conclusion of the contract [2] regulating that operation. Whilst simple transactions carried out in daily life are usually not negotiated, the making of complex contracts requires a preliminary stage of negotiation (**pre-contractual phase**) in order to reach the actual agreement stage, and the signing of a definitive written document is only the final step taken after an agreement on all aspects of the deal has been reached.

Depending on the particularities of the specific case, each contract has its own history and features. Nonetheless, it is possible to classify contracts in different types and according to various criteria. For the purposes of this text the following three deserve mention:

1) With respect to their **formation**, contracts can be formed either immediately or after a process of progressive negotiation. In the first case, when the contents of the contract are fully pre-determined, and in particular when the parties are physically present, the declaration containing the offer and the declaration of acceptance are formulated simultaneously, or in any event within a very short time-frame. The conclusion of the agreement is therefore simultaneous with its formation, no preliminary stage of negotiation being undertaken by the parties, and the contract is immediately legally binding.

[2] The expression "conclusion of the contract" is here to be understood as the final stage of the contract's making, attained when the parties have completed and given legal validity (*e.g.* by signing a written document) to their agreement. It will be noted that in common law systems this stage is also termed "contract execution". This expression may be misleading, as in most civil law systems the term "execution" (*esecuzione*, *execution*, etc.) is used to denote the stage of performance, as defined in footnote 4.

On the other hand, a progressive contract requires various stages of negotiation and, quite often, also the drafting of pre-contractual documents, preliminary contracts or other forms of understanding. As remarked above, such a long process of formation is typical of complex contracts of any kind, and as such is very common in international transactions.

Many types of contract can be formed either immediately or progressively, depending on the specificities involved. For instance, as regards a contract of sale, if I buy a book in a bookshop, the conditions of such a transaction (price, quality, delivery etc.) are pre-determined and the contract is formed immediately upon my payment of the price at the cash desk, but if I buy industrial equipment, before signing a contract I shall probably need to negotiate a significant number of aspects and conditions of the deal with the seller.

2) Contracts can be classified also in view of the modalities of their **conclusion**.[3] In concluding a contract, the parties give legal force to the agreements reached between them and undertake certain obligations. Once concluded, the contract becomes enforceable and the parties can be legally compelled to comply with it.

But how do parties actually bind themselves under law? Generally, contractual obligations are undertaken expressly, through an oral or written agreement: in many jurisdictions, in some limited cases, agreements may also be concluded with no form at all but merely as a result of certain conduct on the part of the parties which bears a specific meaning (so-called **implied contracts**).

In express contracts the parties state the terms of their agreement, either orally or in writing. On the one hand, the oral conclusion of a contract is an uncomplicated and time-saving procedure. On the other hand, without a written text the parties may well be unable to regulate in detail the substance of their contract and, eventually, also find it difficult to prove their respective understandings before a judge.

This is the reason why, in the practice of international business, but also and in more general terms in the practice of all complex transactions, contracts are almost always laid down in one or more written documents, often with the assistance of lawyers. In almost all jurisdictions, the law requires certain types of contracts to be made in writing: this is usually the case of contracts involving the transfer of real property (as prescribed, for example, by art. 1350 of the Italian Civil Code), or the establishment of a limited liability company.

3) Contracts can also be classified, with respect to the time required for their **performance**,[4] either as simultaneous or long-term. The main example of the

---

[3] See footnote 2.

[4] By the term "performance" we mean the discharge of obligations as required of the parties to a contract.

first kind is, again, the simple contract of sale, whereby a party (the seller) transfers the ownership of the good and the counterparty (the buyer) simultaneously effects payment of the price.

On the other hand, as we have seen above, the parties may wish to create a long-term agreement,[5] the duration of which can be limited or unlimited, there remaining, as an effect, some future act to be performed or some obligation to be discharged long after the conclusion of the agreement, in accordance with its terms. As observed, this may be for example the case with supply contracts, but also with many other types of contract like, for instance, those for employment, licence of intellectual property rights, lease, partnership, etc.

3.2. Negotiation

Negotiation is the first step in the process of formation of the majority of international contracts, and the content and length thereof usually vary according to the complexity and economic value of the contract involved. Almost all major business transactions are characterised by lengthy and complex negotiations: in such cases, the definition of contractual terms is progressive, and the partial understandings progressively reached in this stage do not yet legally bind the parties.

The whole of the preparatory activity carried out by the parties before reaching the final agreement is called the **pre-contractual phase**.

In cross-border transactions, which typically place into contractual relations subjects speaking different languages and belonging to different business environments, the process of reaching an agreement that will meet the expectations of both parties often turns out to be more complicated than in domestic dealings.

If the negotiation succeeds, the parties thereby reach the balancing point of their respective interests in the planned transaction and a mutual understanding of the rights and obligations to be set forth for each of them.

But what do parties need to agree upon? An enormous number of topics could be brought to the negotiating table, depending on the specific type of contract under discussion.

Just to give an example, in a contract of commercial distribution of certain goods, the parties will probably, first of all, discuss the basic economic conditions of the agreement, such as the quality, quantity and price of the goods, to

[5] The *UNIDROIT Principles of International Commercial Contracts 2016* define a "long term contract" as a contract to be executed over a period of time that normally involves, to a varying degree, complexity of transaction and continuing relations between the parties.

deal only at a later time with less critical issues like the place of delivery or the modalities of payment. Only when all the elements of the deal have been agreed by the parties can the final contract be drawn up and signed.

Bargaining power

In business negotiations, the respective strength of parties is often uneven: in other words, one of them enjoys more **bargaining power**.

An advantageous negotiating position may be the consequence of various factors, such as dimension, technological level or financial strength. Other key elements are the readiness or capacity of a given party to invest money in negotiations (*e.g.* by retaining lawyers or external advisors) or the availability of appropriately skilled human resources to be employed in the negotiations. The time factor is important as well: it will be clear that a party eager to conclude a contract is more likely to accept less favourable conditions just to speed up the negotiation process.

Also, the existence of an institutional or relational network behind a given party may be a crucial factor. For example, when seeking to make a contract in China with a Chinese company, it is easy to feel the impact on negotiations brought about by the strong connections existing in that country between its main political, financial and business players.

3.3. Good faith

Even though the construction of the contract has not yet been concluded and, therefore, no legal obligations yet bind the parties, they have the duty, in the pre-contractual phase as well, to follow certain fundamental rules of conduct.

The minimum standard of behaviour is generally embodied in the duty to negotiate in **good faith**. The familiarity of the term "good faith" – even beyond its strict legal meaning – does not, unfortunately, help us provide a precise definition of the legal concept.

When applied to the negotiation stage, **the principle of good faith** – a key element of ancient Roman law widely absorbed by the continental European legal tradition – translates into obligations of many forms that differ from legal system to legal system. For example, the Italian Civil Code, requires each party to conduct itself in accordance with the principle of good faith, and prescribes specific duties of disclosure, clarity and confidentiality. When a party fails to observe a reasonable standard of fairness, for instance by providing a negligent or a fraudulent misrepresentation of the contractual elements, it is in breach of the duty to act in good faith.

The variety of ways in which good faith in bargaining is perceived, interpreted and applied in the different legal systems is effectively illustrated in the following considerations by a common law judge:

In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that

they should not deceive each other, a principle which any legal system must recognise; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as "playing fair", "coming clean" or "putting one's cards face upwards on the table."(…) *English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness. (Lord Justice Bingham).*

Since it is clear that the concept of "good faith" may be subject to different interpretations depending on the applicable legal system, what, in practice, should parties do in order to conduct their negotiations in good faith?

Firstly, parties to negotiation are to enter into the process only if they sincerely aim at entering into contractual relations. Negotiation should not be conducted with the mere purpose of acquiring significant information about the counterparty, or of diverting its attention from possible alternative business opportunities.

Obviously the negotiation stage implies, for each party, expenditure of time and economic resources. A party that pretends to be negotiating an agreement but has, in fact, no real intention to conclude it, or that at a final stage of a long process suddenly abandons it without providing any reasonable justification, may cause significant harm to a counterparty that has been counting on the imminent conclusion of a contract. This is one of the moments at which the principle of good faith comes into play: the harmed party has the possibility of obtaining judgment against the counterparty for compensation for loss of profits or loss of opportunity due to the fruitless effort to reach the intended agreement.

Another rule of conduct dictated by the principle of good faith is the requirement for each party to provide the other with all essential information about the object of the deal envisaged, thus allowing reciprocal ascertainment of an actual interest in the making of a contract. Such duty is breached when one party intentionally misleads the other about the object of the contract by failing to disclose relevant information which, if known by the latter, would lead it to a different decision. For example, in the case of an insurance contract, the insured party who intentionally does not provide the insurer with all the information required to determine the risk, is in breach of the duty of good faith. In addition to this, each party should use a language that is clear and intelligible in consideration of the counterparty's cultural level and specific competence, refraining from causing confusion for the latter or taking advantage of his or her lack of knowledge. Parties to negotiation must also keep information obtained therein confidential.

To sum up, the principle of good faith in negotiation constitutes a general condition of fairness, the content of which cannot be predetermined in a precise manner. As stated above, the extent of parties' liability before reaching a final agreement varies substantially from country to country. Thus, at international level, the consequences of conduct contrary to standards of good faith will de-

pend on the applicable legal framework, which may be either that already chosen by the parties at the negotiation stage or that determined in accordance with the rules governing potential disputes. In cases of doubt as to the law applicable, the judge or the arbitrator may find useful to consider, at least as a means for integration and interpretation of the parties' behaviour, the UNIDROIT Principles, which constitute an attempt to provide a uniform solution based on the civil law tradition.

The main UNIDROIT provisions on good faith in negotiation read as follows:

> *Article 1.7 Good Faith and Fair Dealing*
> *(1) Each party must act in accordance with good faith and fair dealing in international trade.*
> *(2) The parties may not exclude or limit this duty.*
> *Article 2.1.15 Negotiation in bad Faith*
> *(1) A party is free to negotiate and is not liable for failure to reach an agreement.*
> *(2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party.*
> *(3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party.*

The UNIDROIT Principles also prescribe a duty of confidentiality, defined as follows:

> *Article 2.1.16 Duty of Confidentiality*
> *Where information is given as confidential by one party in the course of negotiations, the other party is under a duty not to disclose that information or to use it improperly for its own purposes, whether or not a contract is subsequently concluded. Where appropriate, the remedy for breach of that duty may include compensation based on the benefit received by the other party.*

3.4. Pre-contractual documents: the letter of intent

Prospective contracting parties, especially in the case of lengthy and complex negotiation, may wish to outline the progress of the negotiation stage by drafting and exchanging notes on the state of the negotiation process itself. Such notes may be formalised as letters, memoranda or "terms of agreement" duly signed by the parties.

The instrument most commonly used to this purpose is the **letter of intent** (LOI). Letters of intent differ in their structure, which may indeed be that of a business letter whereby the sender presents a text to the recipient for examination, confirmation and signature; otherwise, LOI structure may closely resemble that of a contract, relating the convergence of the parties' intentions and bidding them to set their respective signatures to the text.

LOIs may differ in substance but they usually list the points of a transaction

on which a common intent has been reached by the negotiating parties. Given that the contract is not yet formed at this stage, the letter of intent is generally **not a legally binding document**, but it nonetheless has a strong moral value for the parties and engages their business reputation. Indeed, its purpose is to ensure that both or all parties have the same understanding of the most important terms of the transaction proposed and to state their intent to proceed with negotiations for the future contract, rather than to bind them to specific terms and conditions.

However, it should be noted that many such pre-contractual documents also contain provisions that are actually binding, such as terms governing the negotiation itself: these may concern, for example, timing for the conclusion of the contract, confidentiality of information exchanged or exclusivity in the negotiation for agreements of similar content.

In any case, the parties must mind the form and wording of the LOI, since it may even be interpreted as binding in its entirety if it too closely resembles a contract (*i.e.* if all the essential elements of the agreement have been established and written in a form that appears definitive). Indeed, even using the legal term (*nomen juris*) "letter of intent" will not completely exclude the possibility of legal consequences arising from the content, as the actual wording may render the agreement enforceable even if such outcome has not been desired by the parties.

In order to prevent misunderstandings and avoid an undesired raising of expectations of those involved, if the parties do not wish to be bound by the LOI's content, it is preferable that the text expressly states such fact and, conversely, specify which of the terms, if any, are to be considered binding.

(See the example of Letter of Intent below).

Preliminary agreements

In some cases, parties to negotiation may decide to draft a document whereby they formally undertake to conclude a final contract subject to certain conditions.

This *preliminary agreement* is substantially different from a letter of intent or a memorandum of understanding in that it actually entails the obligation (and not merely the intent) of one, both or all parties to conclude a final contract within a certain period, usually subject to conditions. In other words, it is a legal promise to conclude a final agreement.

Such agreements are suitable for situations wherein the parties have not yet covened on all details but nevertheless wish to commit themselves to concluding a main contract in the near future.

If one party breaches a preliminary agreement to conclude a contract, the other may request the court to order it to pay compensation not only for damages and expenses arising from the negotiations, but also to effect specific performance of the obligations contained in the envisaged contract. Also, the parties use to stipulate in the preliminary agreement a contractual penalty to be paid by the party in breach.

LETTER OF INTENT

NOMEN JURIS

This Letter of Intent is signed on June 23, 2017 in Nanjing (PRC) by and between:
[COMPANY's name], incorporated under the laws of China, with registered office in Beijing, Badaling Development Zone, Yanqing District, represented by _____, (hereinafter referred to as "Party A")

HEADING: PARTIES IDENTIFY AND DESCRIBE THEMSELVES

and

[COMPANY's name], a limited company incorporated under the laws of Italy, with registered office in Florence, Viale Europa 12, represented by _____, (hereinafter referred to as "Party B")
WHEREAS, Party A is a limited company duly incorporated under the laws of the PRC which conducts its business, inter alia, in the field of industrial production of furnishing objects, stationery, gadgets, decoration and gift ideas;
WHEREAS, Party B is a limited company incorporated under the laws of Italy which conducts its business, inter alia, in the field of production and distribution of home accessories and decorative items in the Italian market;
WHEREAS, Party A and B already entered into a mutually fruitful contractual relationship for the supply of three lots of decorated Easter eggs;
WHEREAS, based upon our discussions over the past month, the Parties are entering into this Letter of Intent for an agreement (hereinafter referred to as "the Agreement") under which Party A will supply its manufactured "singing Christmas trees" (hereinafter referred to as: "the Product") to Party B.
NOW, THEREFORE, in consideration of the foregoing the Parties wish hereby to summarise in this non-binding Letter of Intent the outcome of their friendly discussions on the matter as follows.

HERE THE SCOPE OF THE PRESENT NEGOTIATION IS STATED

1. The Parties agree to negotiate in good faith, starting from the date of execution of this Letter of Intent, the Agreement for the supply of the Product.

THIS PROVISION BINDS THE PARTIES TO THE DUTY TO NEGOTIATE IN GOOD FAITH

2. Description of the Product (…).

3. The price to be paid for each unit of the Product shall be determined in the Agreement, reasonably within the range of Euro 1,2-1,5 (CIF Genoa).

4. The Parties will endeavour their best efforts to execute such Agreement within 60 days from the date of execution of this Letter of Intent.

WITH THESE PROVISIONS, THE PARTIES INTEND TO SET AN INDICATIVE

5. Given the nature of the Product, the Parties acknowledge that Party A shall deliver the Product in the agreed date, with no delay. Punctuality of delivery shall be considered as an essential term of the Agreement and a penalty for delays shall be provided for.

DEADLINE FOR COMPLETING THE FUTURE AGREEMENT

6. The Parties agree to discuss the possible future establishment of a joint enterprise for the production and distribution of the Product and of similar decorative items, two years after the successful implementation of the final Agreement.

HERE THE PARTIES AGREE TO DISCUSS THE POSSIBLE DEVELOPMENT OF THEIR CONTRACTUAL RELATIONSHIP

7. By the signature of this Letter of Intent and for a period of at least 90 (ninety) days there from, the Parties undertake to abstain from negotiating contracts covering the same subject of this Letter of Intent with any third party.

THIS IS AN EXCLUSIVITY CLAUSE (STAND STILL), A LEGALLY BINDING CONTRACTUAL OBLIGATION

8. Each Party agrees to treat the content of this Letter of Intent and any information received from another Party as strictly confidential, unless such information is of public domain, and to use such information only for the purposes of this Letter of Intent.

THIS IS A CONFIDENTIALITY CLAUSE, ALSO A LEGALLY BINDING CONTRACTUAL OBLIGATION

For Party A _____ (The Legal Representative, _____)

For Party B _____ (The Legal Representative, _____)

SIGNATURES OF THE LEGAL REPRESENTATIVES OF THE PARTIES