Chapter 4
Drafting of international contracts

4.1. Introduction

As remarked in the previous chapter, parties to an international contract generally opt for establishing in writing the agreement reached throughout negotiation. In some cases, it is the law applicable to the contract itself that requires the agreement to be made in writing, or in line with certain formalities (*e.g.* as mentioned, Italian law requires contracts for the conveyance of real property to be made in written form).

The drafting stage is a delicate one: in drawing up a contract, the parties state in black and white the substance and terms of their respective obligations. Crystallised in a formal written document, the agreement serves as the legal base governing relations between them: it becomes "the law of the parties".

Acting as "legislators" for themselves, the parties should be able to find in the contractual text a clear definition both of the rights to which they are entitled and of the obligations that they have agreed to assume: the confines of such rights and obligations must be as precise as possible in order to avoid misinterpretation or need of further discussions. Also, it should be taken into consideration that if any misunderstandings or disputes arise between the parties, a third subject (an arbitrator or court) will be called upon to resolve the issue; thus, such decision will come from someone who has not taken part in the contract's negotiation and has no other means with which to interpret the will of the parties than a reading of the terms and conditions as stated on paper. For this reason, it is essential that the contract be drafted in such a manner as to leave no room for divergent interpretations, or ambiguities.

However, the main reason why the proper drafting of a written contract may prove crucial consists not only in the text's major role in guiding the parties and possible interpreters to a correct understanding of the agreement, but also in the utmost importance of using a form suitable to produce a contract that is rational, intelligible and in compliance with applicable law. This is mainly the task of lawyers.

4.2. The role of lawyers and law firms in cross border transactions

Even more than the negotiation phase, the drafting phase is usually carried out on a basis of strict cooperation between company managers and business lawyers.

The growth of international business and trade in the last decades has transformed not only financial, accounting or advisory services, but also the legal profession. Since multinational enterprises started to expand further abroad and as new countries and players have emerged in global markets, several law firms – entities that in the past used to be very conservative professional groupings, practicing only their own domestic law – have also improved their international capacity and started to expand internationally, becoming global providers of legal services.

In international practice, lawyers usually operate within large firms able to provide all the legal services that may be required by clients in relation to a given transnational deal (corporate, finance, administrative compliance, intellectual property, labour, litigation etc.). Large law firms operate as companies, in some cases with several thousand professionals and specialised employees, and dozens of offices in the world's main financial centres. The role that they play, together with banks and financial advisors, in the structure and implementation of large international transactions is increasingly crucial.

Despite the still strong prevalence of national law in matters of international business, the need for an understanding of common business practices and legal technicalities and the use of English as a common language tend to make law firms' practice quite uniform at the global level: today, the work of an international business law firm based in Shanghai is very similar to that of a firm based in Milan.

Business players daring to enter into contracts without the assistance of legal counsel are likely to take for granted seemingly uncontroversial matters which, in the event of dispute, may lead to a court ruling or arbitration award contrary to their intentions. That is why the drafting stage should, preferably, be conducted in consultation with knowledgeable professionals; lawyers may advise the parties on the legal implications of their written statements, point out possible ambiguities or gaps left in a draft, provide information on the legal framework applicable to the planned contractual relationship and, in general, carry out all consultative functions aimed at minimising the risks borne by their clients and protecting their legitimate interests.

4.3. Drafting style and standards

With only a few exceptions (such as those due to effects at national level for States party to the UN Convention on Contracts for the International Sale of Goods, there is no uniform legislation governing the rights and obligations of parties to international contracts: contracts are governed by national laws in very different ways, and many types of contract are not even fully codified in domestic law (see above: Chapter 2).

Therefore, in international business, contracts tend to be drafted in such a manner as to construct an autonomous "micro legal system" governing the contractual relationship between the parties in its entirety. Functioning as the law of the parties, potentially detached from any other legal framework, contractual texts need to be as **self-sufficient** as possible (as is customary in the common law tradition). This means that the contract must contain a thorough regulation of the contractual relations, providing beforehand a solution for any potential interpretative problem or dispute which may arise in the course of execution.

However, it must be realistically observed that the text of a contract, despite the efforts made in drafting to produce clear and precise wording, cannot provide regulations to deal with all future contingencies. When the parties find themselves in a situation that has not been covered in the contractual text, their issue must be resolved through recourse to **supplementary law** (see above: Chapter 2), consisting in the law chosen by the parties or, failing such choice, determined by the applicable rules regarding conflict used to fill the gaps left by the parties in their text.

By drafting extensive contracts, parties aim at minimising the need to resort to supplementary, external sources of law in order to regulate their own interests and thus leave as little as possible to the discretion of the interpreting entity. Such practice intends to protect the substance of the parties' agreement, so that the provisions established by mutual agreement do not need any further integration or interference.

The drafting style of international contracts is heavily influenced by international technical and terminological standards and is usually quite uniform at global level notwithstanding the law applicable to the matter involved or the place where contractual obligations must be discharged. There may of course be exceptions but, although one cannot rule out the possibility of international contracts' being drafted with a certain local flavour – especially when the "home" party has the greater bargaining power –, the use of common standards and formats and of English as the contractual language, is generally preferred.

Moreover, contracts drafted in English by professionals who have often been educated in countries of the common law "family" will normally follow the contract models adopted in Anglo-Saxon systems. Given the widespread availability and use of such models in international contract drafting practice, busi-

ness players from a civil law background have also adopted the habit of using British or American contract models, even for the governing of relationships existing under different law. Other factors may be considered in order to explain the predominance of these models in international practice: in the first place, the economic power of multinational companies based in the US, UK and other English-speaking countries that have dominated the international markets over the last century and are therefore able to impose – whether by might or by prestige – their legal models. Secondly, the role of major global legal, consultancy and accounting firms, of banks and financial institutions sharing a common working style that is closely connected with English as a common language. It is also worth mentioning that, compared with civil law, which is based mostly on abstract and universal rules, the common law system (and its contractual models), is, generally speaking, more responsive to the changing needs of business and more effective in resolving concrete problems, and is thus deemed better suited for international trade.

Irrespective of the reasons for its global diffusion, it is evident that the adoption of the Anglo-Saxon model may, on the one hand, contribute to the harmonisation of contracts and, on the other hand, create certain friction in their interpretation and execution, especially in cases where a common law-inspired contract is governed under the law of a civil tradition country.

Among the technical legal models that have an influence on the international harmonization of contract law the **role of the ICC, UNIDROIT and other international institutions** (see above: Chapter 2) is also to be taken into consideration: the ICC principles and certain model texts play an important part in developing common contractual terms and interpretative tools that prove useful in international business. Model contracts and clauses published by the ICC Commission on Commercial Law and Practice provide a global, neutral, common framework for international contractual relations, and thus help to avoid imbalances between legal systems and practices: one example of a successful model text elaborated by the ICC is the "ICC Force Majeure Clause", which will be described below.

4.4. The language of contracts

Parties to international contracts typically speak different languages and do not easily understand one other. But contracts must represent (and regulate) as precisely as possible the understandings reached by the parties, and therefore should be fully understood by each of them.

The language problem arises, first of all, in the negotiation phase: increasingly and throughout the world, the vehicular language in business talks is now English, but bilingual negotiations remain quite common and interpreters still

play an important role, particularly when transactions involve less sophisticated, or less "globalised", parties.

But it is in the drafting phase, when the parties must set forth clearly the terms of their prospective agreement, that linguistic difference becomes a real issue.

Here again, a possible solution is to draw up a **bilingual contract**, thus providing each party with a version of the agreement in its preferred language. This solution has the advantage of being fair, as each party will be familiar with the language of the contract, but is likely to raise some issues.

In the first place, it implies an accurate and technically precise translation of a text from one language into another: this process requires a high degree of expertise on the part of the translator both in the languages and the legal terminology involved, and in many cases such expertise cannot be taken for granted.

Furthermore, to cope with any possible inconsistency between the two versions, the parties will have to decide which will be the official or the prevailing one.

For instance, a clause specifying the choice of language might read as follows:

This contract is written in both the English and Chinese languages. Both versions shall be equally valid and effective but, in the event of inconsistency between them, the English version shall prevail.

(See also article 25 of the Distribution Contract, Chapter 8).

If the parties do not opt to specify a prevailing language, they may, however, attempt to give certain more "creative" indications to assist in the settlement of disputes arising from a conflict between two linguistic versions having equal status, for example by specifying that the contract must be interpreted having regard to all relevant circumstances of the matter, including any practices and usages established by the parties or regularly observed in international trade. They may also provide that when a term proves unclear in one version, reference shall be made to the other version.

Should the parties not opt to the prevalence of one linguistic version or the other, both versions shall theoretically have the same value and the risk of internal inconsistencies and unforeseeable interpretations becomes material.

Alternatively, the contract can be drafted in only one language, a solution that reduces the risk of conflict in interpretation of provisions. The choice will fall either on the language of one of the parties, usually that holding the greater economic power, or on a **neutral language** which both parties master at a similar level.

As mentioned, English is very often chosen as drafting language for international business contracts, but there may be factors leading to the choice of another, more suitable language, for example, the language of the place where the main obligations must be discharged or, with a view to facilitating the settlement of possible disputes, the language of the jurisdiction in which a claim is most likely to be lodged should a party seek judicial enforcement of the contract.

Finally, it should be noted that, besides the choice of language of the contract, the parties may decide to regulate other linguistic aspects of their business relations, for instance those regarding the formal communication between them or the language to be used in possible arbitration proceedings.

4.5. Well-drafted contracts

Although contracts may vary in form and substance according to the specific transaction that they are designed to regulate and according to the cultural and legal background of the drafters, there are certain guidelines to follow in order to write a "good" contract, that is to say, a contract that will best fulfil the parties' expectations, minimising the risk of controversies and/or of undesirable outcome thereof. In order to attain this result, the contract should try to anticipate all problems that may arise, as well as provide for the unforeseen.

It is commonly accepted that a well-drafted contract should have the following two main characteristics:

– **Coherent logical scheme**: the drafting of long contractual texts with a great number of clauses implies a risk of repetition, or of formulation of terms in contradiction with one another. Therefore, it is necessary to write each clause having regard to the whole contractual construction, so as to create a consistent and coordinate system precluding internal conflict. The sequence of clauses should follow an internal logic, and transition from one to the other should be clear and precise. Moreover, contracts often include several distinct documents: it is important to verify that the relations between these are clearly established and that they are accurate and consistent in style and content. Even if the parties have done their best to avoid them in the drafting stage, inconsistencies may nonetheless emerge at a later stage during execution. For this reason, it may be worthwhile to establish explicitly a hierarchy amongst the documents forming the contract so that, in the event of conflict, those interpreting it may know what documents prevail over which others.

– Unambiguous content and **clear language**: the content of a contract should be intelligible to the contracting parties, not only during negotiation and at conclusion, but also in the time subsequent. Moreover, the drafter should bear in mind that the contractual text must be readily understandable also for subjects who have not participated in the negotiation, and who may be called upon to interpret the terms or resolve a dispute long after the agreement has been formalised. To this end, the parties should take care to use unambiguous contractual terms: these should be understandable also when placed outside of the context known to the contracting parties or their lawyers.

The parties usually come from different cultural and linguistic backgrounds and may not be familiar with legal terminology. It is therefore essential to avoid obscure terms, jargon and highly technical wording liable to compromise their understanding of the text. This does not imply that the use of sophisticated legal language is to be excluded *tout court*: obviously, it may be unavoidable when complicated legal or financial matters are involved. However, the drafters should take care not to make undue use of technical legal terminology and employ only such technical terms and expressions as are strictly required, providing – when necessary – definitions. In general, syntax should be simple, without overlong sentences, and all terms used should be clear and unambiguous: their meaning should be unequivocal, leaving as little room as possible for different and potentially contrasting interpretation. Accordingly, the drafters should, if possible, make sure that each concept, item or person is designated by one term alone, for referring to the same entity by two or more terms is liable to create ambiguity, leading to future misunderstandings. Along the same lines, a given term should not be used to denote different items or persons. To avoid the risk of ambiguity, key terms may be explained in a dedicated terminology section, as illustrated below.

4.6. Introductory elements

As noted above, the components of a contract may vary greatly depending on the nature and complexity of the economic transaction that it reflects. Whilst a general description of the structure of international contracts is impossible (since it would have to be one of all the countless clauses and of the terms that they might contain), there are certain formal aspects of contractual structure, developed in professional practice – particularly, but not only, in the drafting of contracts in English – that may be considered quite standard in international contracts.

Contracts are usually divided in several parts, the first usually containing some introductory or preliminary information and, in particular:

– a **title**, defining the scope of the transaction (*i.e.* contract of sale, trademark licence, distributorship). The title should be **consistent with the substance** of the contract: in case of discrepancy between the two, the entity interpreting the contract must examine the content of the clauses which, generally speaking, prevails over the wording of the title (in line with the general principle whereby substance prevails over form);

– the **identification of the parties**, the **date** on which and the **place** where the document has been signed, and possibly the **date** on which the contract is to

enter into force. If the parties are legal persons, as is often the case in international business, their main characteristics are described in this part (*e.g.* type of company, place of registered office, tax payer's identification number, name of legal representatives, *i.e.* the subjects who are appointed to act on the company's behalf according to the law or to the constituent document of the legal person, etc.). Subsequent reference to the parties may be facilitated by introducing designations after their names: for instance, "[name of the party] hereinafter referred to as *Party 1*"or "[name of the party] hereinafter referred to as *the seller*"(in the latter example, the designation obviously depends on the type of contract);

– a **preamble**: an introductory part of the text which is usually situated before the body of obligations.

The preamble consists of statements of facts (**recitals**) that underlie the agreement; it summarises the essential business arrangement between the parties (context recitals) and explains why they are entering into an agreement (purpose recitals). Taking as an example contracts written in English, this section is usually easy to identify, with all its paragraphs introduced by the word "whereas", literally meaning "given the fact that" or "considering that".

Here the parties may explain their respective businesses and describe the history of any existing contractual relations between them.

In keeping with their illustrative function, the statements forming the preamble must be correct and truthful, but usually they do not themselves create obligations for the parties; if the parties consider certain circumstances to be essential for the discharge of their obligations, they should preferably insert a clause in the contract's text as a condition for its effectiveness. However, the preamble plays a role in the definition of the wishes and expectations of the parties and is an important instrument with which both to interpret the contract univocally and to fill in any gaps that the parties may have left in the body thereof.

Also, certain circumstances obtaining at the moment of the contract's conclusion may be considered essential for the discharge of obligations: should such be the case the parties should insert a clause expounding that fact. The substance of the preamble can also be strengthened by the insertion of a clause stating that the preamble is an integral part of the contract.

In particular, it is common to include in the contract – often in its introductory part – certain "representations and warranties" (**reps & wars**). These are guarantees or promises enshrined in a contractual clause whereby one party provides assurance to the other that specific facts or conditions either exist now or will exist in future. For example, in a contract for the sale of goods, the seller warrants that he or she is the owner of the goods, that the goods correspond to what is stated in the contract in terms of model and manufacture, that they are free of defect and will be so for a specific length of time etc. If the seller does

not – for instance – actually have authority to sell the goods, the buyer may be entitled to obtain judgment against him or her for misrepresentation and/or fraud. Representations and warranties may be particularly crucial in corporate mergers and acquisitions (M&A) and joint venture contracts, where they are usually contained in a specific section;

– **definitions**: as aforementioned, it is important that the terms of a contract be clear in their meaning and understandable in like manner for different readers at different moments. Providing definitions for those terms most used or most central may aid in avoiding problems of vagueness and ambiguity of wording, and will dispense the parties from the need to clarify the intended meaning of a given word or concept each time it is used. Misunderstandings are likely to occur when a given word takes on different meanings, depending on the context in which it is used; in particular, it often happens that business or legal language makes use of apparently common terms, whilst giving them a rather specific and technical denotation. To avoid multiple interpretations of a single word, the contract should specify when certain terms are not to be understood in their ordinary meaning. All important terms in the agreement should be specifically defined in a terminology section: this is especially true for terms that are specific to a given economic sector, or for concepts appearing more than once in the text.

According to Anglo-Saxon practice, one way in which to distinguish the defined terms from the ordinary ones is to capitalise the first letter of the former. For example, in a distributorship contract the term "Territory" could be defined as the geographical area in which a certain product should (and could) be distributed by one of the parties;

– **division in articles**: the body of the contract will typically be divided in sections (or articles), which can be further split into enumerated subsections (or paragraphs, sub-paragraphs etc.) in order to provide a clear structure for the content and facilitate reference to specific provisions. Groups of articles dealing with the same topic may be introduced by headings, and short marginal notes can be inserted beside certain contractual provisions to indicate their substance, thus facilitating the reading of the text.

4.7. The body of obligations: contractual clauses

The body of the contract incorporates the provisions that the parties have agreed upon, which are set forth in contractual clauses. Each clause should address an aspect of the parties' relations, detailing the agreement so as to make it understandable for all entities concerned or potentially concerned. In the prac-

tice of international business law, not only in commercial contracts, but also in M&A or licensing agreements, lawyers often use standardised contractual clauses, which usually consist of similar, if not identical, contents and wording.

However, the process of designing and drafting a contract cannot be reduced to a copy-and-paste operation, for some clauses concern the core of the agreement and therefore depend to a large extent on the specificity of the contract's subject.

Contracts are creative tools for business, drafted according to different styles and applicable to an extremely wide range of transactions: it is therefore almost impossible to provide a complete taxonomy of the clauses that may be contained in a contractual text.

However, for descriptive purposes only, it may be useful to distinguish among five main categories of clauses: (i) typical clauses; (ii) common clauses tailored to the specific needs of the transaction; (iii) clauses related to the duration, validity and effectiveness of the contract itself; (iv) risk allocation clauses; and (v) clauses related to the enforcement and interpretation of the contract, applicable law and dispute resolution.

4.7.1. (i). Typical clauses

Some clauses could be defined as "**typical**", in the sense that they contain the core obligations undertaken by the parties in a given specific type of transaction.

For example, contracts having as their object the provision of goods or of a service against payment of a price (contract of sale, supply etc.) will usually contain clauses like the following:

– Description of the goods or service

This clause serves to identify the object of the transaction, describing its quality and quantity. It is particularly important for the party that must sell/deliver, since the sale/supply of goods or services failing to match such characteristics will constitute a breach of the contract.

(See also article 1 of the Sale Contract, Chapter 7).

– Contract price

The price of the goods or services that are the object of the contract, together with the payment method adopted, should be clearly specified in the chosen currency, in both figures and words. Should the parties not wish to agree on a specific price, they may nevertheless determine the price through other modalities, for example by referring to certain indices or to current market prices. In addition, the parties can defer the determination of the price to an independent third party, for example an expert in the industry or a chartered accountant.

(See also the reference to Exhibit A of the Sale Contract, Chapter 7).

– Minimum purchase quantity order

The parties may set a minimum quantity of goods or services that must be purchased in a month or in a year. They may also provide for specific penalties if said minimum quantity is not purchased.

– Delivery Terms

Place, time and modalities of delivery of the goods or service should also be precisely described. The clause doing so can include provisions on suitable transport, insurance coverage, risk of loss, delayed payment and all other issues related to the transfer of the goods from one party to the other.

(See also clause 3 of the Sale Contract, Chapter 7).

As contractual types are very numerous and diverse, in other types of contracts, *e.g.* a joint venture agreement, such clauses would be completely different and would cover entirely different matters, such as, for instance in this case, the respective contributions of the parties to the joint venture's capital or the governance of their company.

(See, for example, Section 4 of the JV Contract, Chapter 11).

4.7.2. (ii). Tailored common clauses

Secondly, as mentioned in point (ii) above, there are clauses that are very common in almost all types of contract, but which should be custom-made according to the specific exigencies of the transaction involved. Just to make a few examples, one may mention those regarding the protection of intellectual property, confidentiality and exclusivity.

– IP protection

These clauses regulate the reciprocal rights of the parties on the intellectual property concerned by the contract. Depending on the kind of contract, intellectual property rights can include technical information, know-how, copyright, models, drawings, specifications, prototypes, inventions or software. If, for example, one party undertakes to provide the other with the know-how developed in the field of the contract's object, it may want such know-how to beheld and used by the counterparty solely for purposes of the execution of the contract, with no dissemination occurring.

(See also article 3 of the Agency Contract, Chapter 9).

– Confidentiality

Another matter that may be included in this category of clauses and that is closely related to those on intellectual property, is the confidentiality to which

the parties are bound with respect to all or part of the information exchanged throughout the life of the contract. Such clauses vary greatly, according to the specific characteristics of the information involved and the specific object of the agreement, but they are crucial for all contracting parties interested in avoiding the disclosure of sensitive commercial data, irrespective of the kind of transaction in which they are engaged. Such clauses may include, for instance, the definition of what constitutes confidential information, the requirements for disclosure thereof, the obligations both of the party disclosing information and of the party receiving it, the term of the obligation, etc.

(See also article 9 of the Agency Contract, Chapter 9).

– Exclusivity

An exclusivity clause binds one of the parties (unilateral exclusivity) or both (bilateral exclusivity) to deal exclusively with the counterparty for a determinate period. For example, in the case of a supply contract, if the clause is in favour of the supplier, the purchaser cannot receive goods of the same quality from any other entity. It has to be noted that such types of clauses are an instrument in restriction of market competition and, therefore, on the basis of the law applicable to the matter, in some cases they may be declared void, either in part or in full, by the competent national antitrust authorities.

(See also article 2(a) of the Agency Contract, Chapter 9).

4.7.3. (iii). Validity and effectiveness clauses

As mentioned in point (iii) above, other kinds of clauses concern the contract itself rather than its subject or the parties' specific obligations, regulating, specifically, its validity and effectiveness. Such clauses are usually incorporated at either the beginning or end of the contract and may include:

– Duration/termination;
– Execution/Entry into force;
– Assignment;
– Severability;
– Notices.

– Duration and Termination

The legal obligations binding the parties continue until the discharge or termination of the contract. Usually, the parties discharge a contract by performing the tasks specified as obligations therein: in order for a party to be released from all liability under a contract, performance should be exact and complete in accordance with the terms thereof. In other cases, the contract terminates by reason of its natural expiration. However, not all contracts come to an end be-

cause the parties have so decided or because they have managed to perform exactly their respective obligations. It may happen that their contractual relations end earlier than foreseen, without attaining their economic objective. In such cases one may speak of the early termination or "death" of a contract. More specifically, the conditions for said early termination may be mutual consent of the parties, breach of a contractual term, occurrence of a specific event or default by one or more parties of their contractual obligations.

A termination clause details the circumstances under which the parties may end their legal relationship and discontinue their obligations under the agreement.

(See also article 11 of the Agency Contract, Chapter 9).

– Right to withdraw

The parties may decide to grant one of them (or even both) a right to terminate the agreement and thus "exiting the agreement" by releasing itself from all its obligations. In many jurisdictions this contractual right is granted and can be exercised regardless of the other party being in default of its obligations and depends exclusively on the occurrence of certain conditions and/or the decision of the party exercising the right to withdraw.

– Execution and entry into force

As remarked in the previous chapter, the agreement reached by the parties has no force of law if it is not duly concluded. Without proper conclusion (or "execution"), the contractual terms remain a dead letter which cannot bind the parties to the obligations stated, and therefore cannot be enforced.

Usually, a contract is concluded when signed, or agreed orally, and there is no need to specify further requirements for its execution. However, as noticed above (see Chapter 3), the parties may decide to make use of preliminary contracts or similar instruments: for example, they may decide that the contract shall be deemed concluded only when formally signed in the presence of a witness who is not party to the transaction (*e.g.* a notary).

Different from the contract's conclusion is its **entry into force**: this is the moment at which the contract starts to produce its effects. Generally, this moment coincides with that of execution, but this circumstance can vary according to the governing law or the will of the parties. Indeed, the contracting parties can decide to postpone the moment of entry into force, or to subordinate it to specific conditions. It is worth noting that it is generally not recommended that the effectiveness of a contract be suspended for an excessively lengthy period: as already observed, time carries the potentiality of changes in factual circumstances which may render the original contractual terms obsolete.

(See above: Chapter 3.1).

– Non-assignment

An assignment or non-assignment clause determines whether rights, obligations and duties under an agreement may be transferred in whole in or part from one party (the assignor) to a third party (the assignee), and the conditions under which this may be done. Usually, most rights under contract are freely assignable, and most duties admit of free delegation, unless the parties stipulate otherwise – for example, in view of the personal nature of an obligation. In such cases the clause will state that rights, obligations and duties are not assignable.

(See also article 10 of the Sale Contract, Chapter 7).

– Severability (partial nullity)

A **severability** clause states what will happen to an agreement if a part of it is declared null and/or unenforceable by a court (*e.g.* due to vagueness, illegality or any other factors). The standard severability clause, in keeping with the principle of continuity of contracts, states that the nullity of one or more parts of the contract shall not imply the nullity of the whole contract or of any other parts. This means that, whenever possible, the contract will continue to have effect between the parties, as if the invalid clause had never been written.

See clause 21.1.1 of the JVA Contract, Chapter 11:
If any of the provisions of this Contract is or becomes invalid, illegal or unenforceable, the validity, legality or enforceability of the remaining provisions shall not in any way be affected or impaired.

However, such a solution will not always suit the interests of the parties, especially in cases where the invalid or enforceable clause constitutes an essential part of the contract, economically indispensable to one of the parties.

As an example, let us consider a long-term contract for provision of services – containing a standard severability clause – prescribing periodic payments by the service customer to the service provider, subject to a high interest rate to be applied to amounts overdue, a condition that the provider considers a vital component of the deal. Such clause is later ruled invalid by the court before which the customer has brought a case. In consideration of the severability clause, the court might decide to sever the interest rate provision and leave the remainder of the contract intact. It is obvious that the provider will not welcome such an outcome, as it would not have concluded the contract without the now severed clause.

To avoid this consequence, the severability clause should be differently formulated. The parties should express their intent that relevant clauses are to be deemed inextricable from and essential to the agreement. This might be done by stipulating that certain terms are so essential to the contract that, should they be ruled illegal or unenforceable, then the remainder of the contract would be void.

Alternatively, in the event of an essential clause being ruled unenforceable, the parties could agree to undertake new negotiations in order to formulate a different version of such clause, one which would satisfy the economic interests of both. As an example, see the following text:

> *Should any provision of this Agreement in whole or in part be or become invalid, impracticable or unenforceable, the validity of the other provisions shall not be affected by such circumstance. In such case, the invalid, impracticable or unenforceable provision shall be deemed to be replaced by a provision the substance of which, to the extent admissible under applicable law, resembles that of the invalid, impracticable or unenforceable provision.*

– Notices

The notices clause defines the modalities of formal communication between the parties, specifying the form of notice (*e.g.* in writing), the modality of its delivery (*e.g.* in person, by registered mail) and the moment at which it shall be deemed received (*e.g.* receipt of confirmation slip).

This clause works in conjunction with other provisions of the agreement stating the circumstances in which notice is required: for example, a party wishing to terminate the contract may be required to send a termination notice.

4.7.4. (iv). Risk allocation clauses

The category mentioned in point (iv) above, is another set of general clauses which is quite common in complex transactions, especially in long-term contracts, and aims at allocating contractual risks on one or both parties, especially when the contractual relationship is expected to be one of considerable duration. The most important of these are:

- Adaptation: Hardship, Price, Currency;
- Force Majeure;
- Penalty/Liquidated damages.

In the drafting process it is important to consider that the life of a contract can be influenced by circumstances beyond the control of the parties or by other factors intervening within the term of the contract.

In general terms, after the parties have bound themselves to certain conduct, they proceed in effecting their respective performances. In some cases, the contract provides for obligations of long duration, that is to say, performance is spread over a considerable length of time. The longer such period, the more likely that the original factual and economic circumstances will change before its lapse. Indeed, just as many unplanned or unforeseeable events occur in the life of a person, so the life of a contract can be affected by intervening factors that change the interests at stake. Some of these events are the so-called "acts of God", *i.e.* events which are beyond the control of the parties and may render the

discharge of certain obligations impossible or alter the balance of interests reached in the agreement.

The relevant contractual clauses may be crucial in such cases, as they can adapt and adjust the contract's provisions to factual changes, avoiding both breaches and the need for dispute resolution.

– Hardship

A Hardship clause anticipates the occurrence of an unforeseeable event affecting the contractual dynamics. Hardship can appear very similar at first sight as they both relate to a contractual relationship in which factual circumstances have changed. The difference between the two resides in the effects that such event has on contractual obligations.

Whilst in the case of Force Majeure (for further details see below) performance becomes impossible, in cases covered by a Hardship clause the contractual element affected by the unforeseeable event is the original equilibrium of the contractual relationship. In other words, due to such event, performance becomes particularly burdensome for only one of the parties, but is, essentially, still possible.

Hardship can be defined as any event of legal, technical, political or financial nature occurring after the conclusion of the contract that renders certain contractual obligations of one of the parties excessively more burdensome or expensive to discharge and that the parties could not foresee at the time of the contract's formation, despite their utmost care.

Let us take one of the explanatory examples given by Unidroit:

> *A enters into a contract with B, a waste disposal company in country X, for the purpose of arranging the storage of its waste. The contract provides for a four-year term and a fixed price per ton of waste. Two years after the conclusion of the contract, the environmental movement in country X unexpectedly gains ground and the Government of country X prescribes prices for storing waste which are ten times higher than before. B may successfully invoke hardship (even if) only with respect to the two remaining years of the life of the contract.*

Different legal systems may or may not stipulate specific regulations for such cases. The Italian legal system is amongst those that incorporate the concept of hardship. Indeed, Article 1467 of the Civil Code states that a party may demand termination of a contract as a consequence of a supervening excessive burdensomeness thereof. The counterparty may avoid such effect by offering to make changes to the original contractual conditions in order to establish a newly balanced relationship.

Where legislation is silent, the issue is resolved through recourse to the universal principle of "*pacta sunt servanda*", which states that contracts have force of law between the parties and failure to discharge obligations thereunder is a breach of that law. According to this principle, supervening changes to the orig-

inal economic situation justify neither exemption from performance of the party in hardship or any modification of the contractual clauses for its benefit.

In international business, the purpose of a hardship clause is to lessen the effect of said general principle, expressly providing for circumstances in which the contract can be modified to facilitate the weakened party's discharge of its obligations.

In practice, in accordance with the clauses agreed by the parties, the contractual conditions may be adjusted automatically in line with the changed circumstances, or the parties may re-open negotiation on the contractual provisions affected by such circumstances.

Several types of solutions are included in international instruments. Both UNIDROIT and the ICC have published standard Hardship clauses to be either incorporated in contracts or referred to therein.

The **UNIDROIT Principles** provide a definition of hardship in clause 6.2.2, which describes it as a situation where "the occurrence of events fundamentally alters the equilibrium of the contract", and the criteria by which to ascertain such events are further illustrated in sub-sections. The effects of hardship are described in clause 6.2.3, which states that the disadvantaged party is entitled to demand renegotiation. If the parties fail to reach agreement within a reasonable time on how to amend the contract in line with the changed circumstances, either party may resort to the courts or to arbitration. On the one hand, such provisions are driven by a willingness to restore equity in the contractual relationship. On the other hand, the intervention of a third entity (judge or arbitrator) in the reformation of the contract is often regarded with disfavour by business players.

With respect to the **ICC Hardship clause (2003)**, it recognises that parties must discharge their contractual obligations "even if events have rendered performance more onerous than would reasonably have been anticipated". However, where continued performance has become excessively onerous due to an event beyond a party's reasonably presumable control, one which it could not reasonably have been expected to take into account, the clause requires the parties to negotiate alternative contractual terms. The party invoking hardship is entitled to terminate the contract in the event that alternative contractual terms cannot be agreed.

– Price-adaptation/Limitation of currency risk

These adaptation clauses allow the parties to vary the price of goods and the currency in which it is to be paid according to changes in market conditions. In some cases, they oblige the parties to renegotiate the contractual terms, whilst in others they prescribe an automatic adaptation of such terms to be effected on the basis of specific indices or indicators.

Indeed, determining a fixed price can be risky, particularly when the con-

tract is to be executed over a lengthy period, since inflationary or deflationary movements may occur. In such cases an "automatic" price adaptation clause may be inserted, linking the price of goods or other elements of the contract to a predetermined, publicly available index (*e.g.* the World Bank Commodities Price Data or the London Interbank Offered Rate – LIBOR). In this way, a price increase or decrease is deemed capable of adjusting the values concerned in line with the contingencies of the economic moment.

The adaptation often relates to matters of foreign exchange. For instance, it could be agreed that "*Prices provided for at the date of signature of the contract are set in US Dollars in accordance with the USD/EUR LIBOR exchange rate operative on the date of signature of this Agreement. In case of a currency fluctuation of more than P% (LIBOR) over a year from the date of signature of the contract to the date of delivery, the price shall be automatically and accordingly adjusted*".

– Force Majeure

The clause of force majeure is used mostly in contracts the effects of which will last for a considerable length of time. As remarked above, if a contract is of long duration, it is likely that some unexpected and unforeseeable events will occur within the period of its validity. Let us consider, for example, the possible consequences of earthquakes, fires, floods or other natural disasters, and those of wars, riots, insurrections, rebellions, acts of sabotage or terrorism, on ordinary business life.

This type of clause aims at regulating those cases in which the occurrence of an unforeseeable event hinders the discharge of an obligation incumbent on one of the parties. In such cases, a conflict between two different interests arises: on the one hand, the interest of one party in being fully satisfied in its contractual expectations, on the other hand, that of the other in being exempted from its obligation when discharge has become impossible due to circumstances beyond its control or authority.

The different national legal systems make provisions regulating non-discharge by a party to a contract in the case of unforeseeable events for which such party is not responsible. For example, in the Italian Civil Code, art. 1256 stipulates that the party's obligation is extinguished when discharge becomes impossible by reason of an event not attributable to itself.

However, this issue is not regulated homogeneously across all national legislations. For this reason, some international instruments have encouraged the use of uniform and "fair" regimes for international business contracts. Amongst such instruments it is worthwhile to recall Art. 79 of the United Nations Convention on Contracts for the International Sale of Goods (CISG), which stipulates a provision for force majeure. Similarly, clause 7.1.7 of the UNIDROIT principles expressly regulates the matter.

The ICC has prepared a standard clause that can be simply cited in the text of a contract as "ICC Force Majeure Clause". This clause is made up of three parts: the first detailing the causes justifying exemption from liability, the second stipulating the duty to notify the counterparty of the circumstances of a force majeure event and the third describing the consequences of such event.

In addition to applicable law and to the international instrument, consistent arbitration case law regarding this matter has been developed. Referring to such case law, even if it is inevitably connected to specific cases, is useful for outlining certain common features of the circumstances of force majeure events. As regards the characteristics of the event from which preclusion of liability arises, such event should:

- be unforeseeable;
- be beyond the control of the parties (irresistible);
- have such effect as to render performance impossible or at least not reasonably sustainable;

(See also article 22 of the Franchise Contract, Chapter 10).

– Penalty/Liquidated damages

When establishing a contractual relationship parties are led to contemplate a possible breach of the contract and to foresee the effects thereof, with the aim of determining in advance the exact amount of damages to be payable in such event and thus avoiding protracted litigation over actual loss sustained.

Consequently, the parties may agree to set a fixed amount of damages for non-discharge of specific obligations. The monetary sum may also be determined as a percentage of the value of such failed performance. This type of clause is versatile and can satisfy different needs of the parties.

First, the penalty clause can be used to determine in advance the amount of damages to which an injured party is entitled in the event of breach of contract. Such provision will exempt the injured party from any obligation to demonstrate the value of its loss.

In such case (**liquidated damages** provision), through the prior determining of a set amount as compensation, the liability for breach and the related obligation to compensate for possible loss is limited to the pre-determined amount of the penalty. A **penalty clause**, on the other hand, is one establishing a monetary value not as compensation for a pre-estimated loss, but rather as an inducement for the party concerned to discharge its obligation. In other words, it constitutes a penalisation of failed performance.

This distinction is relevant insofar as the two types of clause are treated differently under different national laws. For example, not all legislations allow penalty clauses (this is especially the case of common law systems). Where such form of penalisation is tolerated by the legal system, often a court will have the

discretion to reduce the amount of a penalty if it deems it excessive. This is the case of the Italian Civil Code, which under art. 1384 provides for a formula linking the penalty clause to the economic value of the contract: "*The penalty can be diminished equitably by the judge if the principal obligation has been executed in part or if the amount of the penalty is apparently excessive, consideration always being given to the interests that the creditor has had in performance*". According to the Court of Cassation, such reduction can be carried out by the judge *ex officio*, without any specific motion by the concerned party.

4.7.5. (v). Dispute resolution and applicable law clauses

Finally, as mentioned in point (v) above, there are clauses that are not related closely or directly to the substance of the contract, but rather to the "external" rules governing its enforcement, validity and interpretation with respect to the jurisdiction chosen by the parties, as well as the settlement of potential disputes arising between the parties in their performance of the agreement.

– Dispute resolution and jurisdiction

Contract enforcement is the mechanism with which to ensure that each party honours – in some cases even against its will, by intervention of a judicial authority – its obligations deriving from a contract. It is merely a potential stage in the life of a contract, coming into play only when obstacles to the contract's natural, spontaneous execution have arisen.

The resolution of disputes clause is one stating the agreement of the parties as to how a possible future dispute related to the performance or interpretation of the contract shall be resolved. As analysed in Chapter 2, almost all legislations in the world, with varying degrees of liberty, allow parties to an international business contract to choose arbitration instead of judicial litigation, usually considered lengthy and uncertain, the rulings of which are difficult to enforce.

This topic will be explored in depth in Chapter 6.

(See also article 15 of the Distribution Contract, Chapter 8).

However, the parties may decide to devolve potential disputes to a court of justice. In such event the issue that immediately arises is the designation of the court that will handle their case. A jurisdiction clause aims at avoiding costly and time-consuming additional disputes as to the location of the court to be designated, or precluding the commencement of two or more parallel proceedings in different jurisdictions simultaneously. With this provision, the parties agree that the courts of a specific country will have jurisdiction over any disputes arising between them.

This topic will be explored in depth in Chapter 5.

– Applicable Law

For the specific development of this topic, please refer to Chapter 2. Below will be found only a brief reference to the Governing Law clause of the JVA Contract, Chapter 11:

> *– 21.4 Governing law*
> *– 21.4.1 This Contract shall be governed by and construed in accordance with the laws and regulations of the People's Republic of China.*

It is pertinent to remark that under Chinese Law the content of this clause cannot be modified by the parties, as it constitutes a mandatory rule.