Unwinding of Contracts

1. Introduction

Two parties enter into a contract and exchange their performances. Then they find out that the contract has failed, for some or other reason, and that it will have to be 'unwound': the parties may never have reached *consensus* and, thus, the contract may have never come into existence, the contract may be invalid (→ invalidity) for lack of compliance with a → formal requirement or → illegality, it may have been avoided as a result of → mistake, → fraud, or → duress, it may have been terminated for → non-performance or one of the parties may have exercised a → right of withdrawal. Henceforth, the term *unwinding factor* will be used to denote these different reasons which are the ultimate cause for unwinding the contract. Unwinding a contract always aims at restoring the parties, as far as possible, to the *status quo ante contractum*. For that purpose, both parties have to give back what they have received under the contract. This sounds rather simple. Yet, a number of difficult questions arise which have to be answered by every legal system. (a) What happens if the parties, or one of them, are unable to give back what they have received, eg because the object has been destroyed or has deteriorated, or the subject matter of the contract is incapable of being returned *in natura*? (b) There is a substantive side to this question: who is to bear the risk that the object received has deteriorated or has been destroyed due to a supervening event? (c) And there is a technical side to it: should a party be barred from requesting the unwinding of a contract if he is unable to make restoration to the other party? Or should he only be liable for the value of what he received? (d) If one opts for a compensatory model, what are the principles for assessing the value of what was provided? (e) If one party has derived benefits from the object received, does that party have to give them back as well? And what about expenses for the maintenance or improvement of the object? (f) Further problems arise in identifying the place of performance, in three-party situations, with regard to long-term contracts, and concerning the applicable law. (g) Finally, there is a systematic question that each legal system initially needs to answer: should the process of unwinding a contract be governed by a number of different regimes or is a unified approach preferable?

2. A unified approach?

German law has developed different regimes for unwinding contracts: if the contract is void, the law of unjustified enrichment (§§ 812 ff → *Bürgerliches Gesetzbuch* (BGB)) will govern the process of unwinding the contract. If the contract has been terminated, the special restitution regime of §§ 346 ff BGB will apply. If a consumer withdraws from the contract, these special provisions are modified by § 357 BGB. Finally, if the transfer of property is also invalid, the *Eigentümer-Besitzer-Verhältnis* (owner-possessor-relationship) contained in §§ 987 ff BGB will be applicable. Each of these regimes will provide different answers to the above-mentioned questions, eg concerning risk allocation. A similar variety of regimes can be found in English and Scots law.

Other European legal systems do not draw such a sharp distinction between different regimes for unwinding contracts. For instance, Austrian law distinguishes between the unwinding of contracts following avoidance for defects of consent (§ 877 ABGB), following termination for non-performance (§ 921 ABGB) and following the exercise of a right of withdrawal from a contract (§§ 4, 5g KSchG). Yet all of these scenarios are governed by the law of → unjustified enrichment (§§ 1431 ff ABGB). The law of unjustified enrichment thus underlies the different regimes as a unifying concept. A similar approach is taken in France and by the Spanish judiciary. In the Netherlands the legislature has aligned the different regimes to each other.

A unified approach can also be found in legal history: in → Roman law, a number of different actions and remedies aimed at setting aside a contract. However, all of them were governed by the principle of *restitutio in integrum*. The *restitutio in integrum* was an extraordinary remedy. But at the same time it described the function of a number of remedies: to restore a party *in integrum*. The unwinding of contracts, with whatever remedy it was achieved, aimed at restoring both parties to the *status quo ante*. 'Restitutio in integrum est reciproca'—that is how a German author of the 18th century paraphrased this principle which Friedrich Carl von Savigny characterized as both general and natural. This overarching principle seems to have included uniform rules on the allocation of risk, etc.

Why has this unified approach been lost in some European jurisdictions? This question has, as yet, only been researched for German, English and Scots law. The distinctions which we observe in these legal systems today have only occurred since the late 19th century. Of great importance has been the distinction that avoidance operates retrospectively while termination has a prospective effect. However, this difference was only introduced in order to award contractual → damages and to uphold limitation-, exclusion-, and arbitration-clauses when a contract had been terminated for non-performance. However, with respect to the unwinding of contracts this distinction proves to be of no relevance.

A unified approach is preferable: the purpose of unwinding contracts is always identical, ie to restore the parties to the *status quo ante*. Furthermore, different regimes will cause inconsistencies, especially if each of them answers the above questions differently. However, such diverging answers could only be justified on the basis of different policies underlying the different unwinding factors. Yet, in German, English and Scots law comparable unwinding factors are attributed to different unwinding regimes whereas distinctive unwinding factors are grouped together under identical regimes. German lawyers are aware of the resulting discrepancies, and they try to reduce them by aligning the different regimes with each other. In contrast, English and Scots lawyers try to justify the differences, eg by referring to the different effects of avoidance and termination.

Although a unified approach is preferable, it is unknown to → uniform law. A European directive introducing a → right of withdrawal (Dir 85/577, 94/47, 97/7, 02/65) or introducing a right to terminate in case of lack of conformity (Dir 99/44) can only deal with the consequences of the exercise of the individual rights. The CISG, in turn, only covers termination for non-performance and its consequences. It therefore follows from the limited scope of application of these instruments that they do not introduce a unified regime for the unwinding of contracts. Furthermore, some of these instruments leave the details of how to unwind contracts to the national laws. But even the → Principles of European Contract Law (PECL), the → UNIDROIT Principles of International Commercial Contracts (PICC), the Draft → Common Frame of Reference (DCFR) and the Proposal for a Directive on Consumer Rights (COM(2008) 614 final) do not adopt a unified approach. The PECL, for example, contain three different regimes, one for unwinding following avoidance (Art 4:115), one for the unwinding of an illegal contract (Art 15:104) and one for unwinding following termination (Art 9:305 ff). Only the *Avant projet* of a → *Code Européen des Contrats* has already adopted such a unified approach (Art 160). The same will be true of the extended, third edition of the UNIDROIT PICC (see Arts 3.2.15 and 7.3.6).

A unified regime of unwinding contracts would not need to be inflexible. One can, for example, take the policy considerations underlying the different unwinding factors into account when answering the question as to the allocation of risk. At the same time one would avoid the danger, inherent in a differentiated approach, of not treating like cases alike.

3. Concurrent restitution

In mutual contracts performance and counter-performance are reciprocal. If a mutual contract is unwound, the principle of reciprocity has to be taken account of even if the contract is void. That is what an 18th-century German author meant when he stated that 'restitutio in integrum est reciproca': the obligation to make restoration of the one party is linked to that of the other.

4. Allocation of risk

Should the recipient of a performance bear the risk that the object received has been destroyed or has deteriorated due to a supervening event? Or should the other party—that is, the party who rendered the performance—have to shoulder this risk? Or should the loss perhaps be split between the parties? The position that this risk should be on the recipient prevails (Germany, France, Italy, Spain, DCFR, but see the Netherlands for a contrary approach). A number of factors, rules and principles are referred to in favour of this risk allocation: 'res perit debitori', 'venire contra factum proprium nulli conceditur', *excep-*

tio doli, 'he who seeks equity must do equity', the parties' reliance, and their will. However, the most convincing factor is that the recipient has control over the object, and that he should thus also bear the risk. Moreover, the recipient is in a position to insure the object.

It is generally accepted that this allocation of risk is only the point of departure and that there must be exceptions to it. Thus, it is beyond doubt that the destruction or deterioration of what has been received is on the other party if it was caused by a latent defect of the object received or if the other party was otherwise responsible for the loss (Germany, Italy, DCFR). Some legal systems also allow exceptions when the recipient was a minor (Germany, Spain, but see Scotland for a contrary approach), when he was defrauded (Germany, France), and whenever the policy consideration underlying the unwinding factor so requires (Germany). Finally, in some legal systems the recipient is released from having to bear the risk if the unwinding factor may be attributed to the other party as in the case of termination for non-performance (Germany).

5. Implementation of risk allocation

But how is the risk-allocation regime to be implemented? We find a number of different models: if it is the same party who cannot give back what he received and who has a right the exercise of which will result in the unwinding of the contract, one may hold that he is barred from availing himself of such right (see the German § 351 BGB until 2001, and Art 82 CISG in case of termination; England, Scotland and Ireland in case of avoidance). Some legal systems distinguish between cases of a material and an immaterial deterioration (France). Yet other legal systems justify the fact that the recipient will be barred from enforcing his rights by reference to a waiver: by using the object received in such a way that it has been destroyed or has deteriorated the recipient waives his rights to claim the unwinding of the contract (Austria in case of avoidance, England in case of termination).

However, this solution is increasingly criticized: in its favour it has always been argued that it avoids problems of assessing the value of the object received. Yet each legal system has to face these problems when, as in the case of services, the performance received cannot be given back *in natura* or when it is the other party who cannot give back an object in the same condition in which it was when he received it. Furthermore, a compensatory model is much more sophisticated. It will not bind the parties to a contract which is void, voidable or otherwise open to termination, but it will restore the parties at least in respect of the respective values of the performances exchanged to the *status quo ante*. Indeed, this is a model increasingly gaining recognition (Germany, Netherlands, PECL, DCFR and to a limited extent France, Spain, Italy, Austria and England). Each party thus has against the other party a claim for the value of his performance if the other party cannot, for whatever reason, give back what he received or give it back in the same condition in which he has received it.

6. Assessing the value

If one opts for the compensatory model, the principles for assessing the value of the performance—which has been received and which cannot be returned or which cannot be returned in the condition in which it was received—are of great importance: one may assess the value of the performance subjectively and argue that the subjective value of the performance received is the objective value of the counter-performance. After all, that was what the receiver was willing to pay for it in the first place. If the objective value is decisive, then it would be possible for one of the parties to escape from a bad bargain. In some legal systems the possibility of escaping from a bad bargain is regarded as problematic if the contract is unwound after termination for non-performance because termination does not avoid the contract *ex tunc* (England, Germany, DCFR). Yet, the different effects of avoidance and termination are of no relevance for the unwinding of contracts. Furthermore, it is not doubted that a party can escape a bad bargain if he is able to restore in kind: if a party buys an object for a price that exceeds its objective value, he can after termination give back the object and will receive back the full price. Finally, assessing the value of the performance received subjectively with reference to the objective value of the counter-performance causes problems in cases in which the parties have swapped two objects and both objects cannot be returned *in natura*.

If one assesses the performance objectively, then it still has to be decided which point in time is decisive. That is important if market values have changed. The relevant date may be the date of the formation of contract (France), of its performance (Netherlands), of the destruction of what has been received (Spain), when one party raises an action to enforce his claim to have the contract unwound, or when the compensation is paid. It seems to be preferable to opt for the date of performance as it is the purpose of unwinding contracts to restore both parties to their *status quo ante* and, additionally, the party who has

control over what has been received should also bear the risk. After all, it is not in the control of the recipient whether the market value of the received performance changes.

Finally, the question of whether the recipient may subjectively devalue what he received is answered differently in Europe. This question arises especially in cases in which a service has been received and the contract is avoided or terminated after partial performance has been rendered to him: may the recipient aver that this part performance is of no value to him?

7. Benefits; expenses for maintenance or improvements

The question as to whether benefits derived from the received performance, such as fruits, also have to be given up, receives different answers in Europe. According to some legal systems only benefits which have actually been enjoyed have to be given up. Other legal systems grant to the other party a claim even for those benefits which the recipient has failed to derive if he ought to have derived them according to good business practice. In some legal systems benefits never have to be given up by a party that acted in good faith. In other legal systems the benefits derived from the use of an object do not have to be restored, but the depreciation of value caused to the object received through its use has to be compensated. Many legal systems adopt different solutions concerning the different regimes for the unwinding of contracts. That again may cause discrepancies which are not explicable on the ground of policy considerations.

It seems to be settled that each party can claim reimbursement concerning expenses for the maintenance or improvement of the object received if these expenses resulted in an enrichment of the other party. Necessary expenses which the other party would have had to incur will enrich him as saved expenses. However, if the unwinding of the contract is based on unjustified enrichment then, *prima facie*, each party may claim that he changed his position no matter whether the expenses were necessary or resulted in an enrichment.

8. Place of performance; three-party cases; long-term contracts; conflict of laws

Especially with international contracts it is crucial to identify the place where the respective obligations have to be fulfilled. The answer to this question will decide who has to bear the risk of, and the costs resulting from, the transportation of the goods. Despite its importance, the comparative literature is silent on this matter. Only some European directives give answers, albeit different ones, to the question of who has to bear the costs resulting from transport (Dir 97/7, 99/44).

The problematic case of unwinding three-party relationships is only mentioned in some European directives concerning → consumer credit agreements. But these directives only determine that when a consumer exercises his right to withdraw from a contract for the supply of goods and services, the credit agreement is also to be cancelled if the credit was rendered to finance these goods or services (Dir 94/47, 97/7). They are silent on the question as to how to unwind the two contracts.

It is well settled in Europe that long-term contracts will not be unwound in respect of performances rendered in the past. However, the European legal systems differ as to how they arrive at this result. The English position is particularly complex and can only be understood against the background of its law of → unjustified enrichment. Furthermore, English lawyers stress that termination only has prospective effect. Thus, it follows that the contract cannot be unwound retrospectively. Only if there is a total failure of consideration may the contract be unwound for the past. In long-term contracts there will generally not be a total failure of consideration for the time before the breach occurred if both parties have already performed their respective obligations. The position is different with, for example, a contract of sale: the seller may reject the defective object and as a consequence there will be a total failure of consideration. From a comparative point of view this line of argument seems overly complex. Furthermore, the distinction between *ex tunc* avoidance and *ex nunc* termination is again of limited value as it is undoubted in Europe that even in the case of an *ex tunc* avoidance the contract will, in some cases, not be unwound for the past (Germany, England, Spain, Italy). The solution of German law which distinguishes between two kinds of termination seems to be more straightforward. *Rücktritt* operates prospectively to the extent that contractual → damages may still be awarded and contractual limitation-, exclusion-, and arbitration-clauses are upheld. However, it operates retrospectively in that both parties have to give back what they have received under the contract. In contrast, *Kündigung* works in every respect only prospectively. The contract will not be unwound for the past. This model lays open the underlying policy considerations and does not hide them behind the unjust factor of total failure of consideration. Nonetheless, the PECL (but not

the UNIDROIT PICC and the Draft Common Frame of Reference) follow the English model.

Even if a unified approach for the unwinding of contracts has, as yet, not generally been accepted, the applicable law is identical for all regimes (Art 12 Rome I Regulation (Reg 593/2008), Art 10 Rome II Regulation (Reg 864/2007)).

Literature. Rainer Hornung, *Die Rückabwicklung gescheiterter Verträge nach französischem, deutschem und nach Einheitsrecht* (1998); Peter Schlechtriem, *Restitution und Bereicherungsausgleich in Europa, vol I* (2000) 403 ff; Markus Krebs, *Die Rückabwicklung im UN-Kaufrecht* (2000); Daniel Friedrich Berg, *Die Rückabwicklung gescheiterter Verträge im spanischen und deutschen Recht* (2002); Christoph Coen, *Vertragsscheitern und Rückabwicklung* (2003); Phillip Hellwege, *Die Rückabwicklung gegenseitiger Verträge als einheitliches Problem* (2004); Reinhard Zimmermann, 'Restitutio in integrum' in *Festschrift Ernst A Kramer* (2004) 735; Phillip Hellwege, 'In integrum restitutio and the requirement of counter-restitution in Roman law' [2004] Juridical Review 165; Daniel Visser, *Unjustified Enrichment* (2008) 475 ff; Reinhard Zimmermann, 'Die Rückabwicklung nach Widerruf von Verbraucherverträgen' [2010] Juristische Blätter 205.

Phillip Hellwege