Mitigation of harm from the perspective of court decisions and arbitral awards

Research Article

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Abstract

In legal theory it is known the maxim: *Any harm that the party who relies on a breach could have avoided by taking reasonable steps will not be compensated*. Commentators have variously described the obligation as a statement of ‘public policy against waste’, ‘a duty to mitigate’, ‘a duty to cooperate’ and ‘an obligation for oneself’. Under this concept the party threatened by loss as a consequence of a breach (fundamental or not) of contract by the other party is not permitted to await passively incurrence of the loss and then sue for damages. He is obliged to take adequate preventive measures to mitigate his loss. The measures the party who relies on a breach is expected to take in order to mitigate the harm must be reasonable in the circumstances. The obligation for reasonableness is to be interpreted taking into account the competing interests of the parties, as well as commercial customs and the principle of good faith. This principle is clearly reflected in Article 77, part of the provisions covering the issues of damages within the United Nations Convention on the International Sale of Goods (CISG). This article has been implemented in a large number of court decisions and arbitral awards worldwide, the selected part is a subject of review and analysis of the author in this paper.

Keywords: mitigation, harm, CISG, decisions, awards.

1. Introduction

Mitigation is a principle which is an obligation in the common law but not clearly defined in civil law. In arbitration practices mitigation has become a general principle of international trade and Michael Mustill refers to the principle as "[to] constitute the lex mercatoria in its present form."¹ He went further by noting that mitigation is merely treated as obvious.² The principle of mitigation of harm requires that a party who relies on a breach of contract to adopt such measures as may be reasonable in the circumstances to mitigate the harm, including the loss of profit, resulting from the breach. This principle states a duty owed by the party who relies on a breach to the party in breach. In this case the duty owed is the obligation of the party who relies on a breach to take actions to mitigate the harm he will suffer from the breach so as to mitigate the harm he will claim. Indeed, if he fails to take such measures, the party in breach may claim a reduction in the damages in the amount which [by which the harm] should have been mitigated. When the party who relies on a breach has undertaken appropriate mitigation efforts and has incurred additional expenses in doing so, it usually may recover these expenses, if

²Ibid, 100.
reasonable, as incidental damages. This is so even if the (reasonable) measures have not been successful.

The CISG has incorporated the doctrine of mitigation specifically into article 77. The idea behind article 77 is that the plaintiff cannot recover damages or losses which he should have avoided: “A party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss, including loss of profit, resulting from the breach. If he fails to take such measures, the party in breach may claim a reduction in the damages in the amount by which the loss should have been mitigated.” This 'duty' to mitigate is an expression of the lex mercatoria, as well as of the principle of good faith in international commerce. Furthermore, the mitigation rule is well recognized in international arbitration practice, and can also be found in most legal systems and judicial practice, as well as in the ongoing projects for the harmonization of contract law: UNIDROIT Principles of International Commercial Contracts 2016 (PICC), Principles of European Contract Law (PECL). By the wording, the solution included in PICC and PECL according the duty to mitigate generally correspond to the CISG, and distinguish between situations where the aggrieved party contributed to the non-performance and those where it failed to reduce the loss by taking reasonable steps.

2. Applicability of the principle in the court’s and arbitration practice

There is a number of court decisions and arbitral awards on which acts or omissions by the party in breach constitute a cause for failure to perform by the party who relies on the breach.

(a) Buyer's failure to pay the price for delivered goods causing the seller to fail to deliver other goods

Belarus 5 October 1995 Belarusian Chamber of Commerce and Industry International Court of Arbitration Case No. 24/13-95 (ATT v. Armco)

A Belarusian seller and a Bulgarian buyer entered into a contract for the sale of refrigerators and deep freezers. After the buyer failed to pay for a portion of the goods received, the seller sued for the remaining purchase price. The buyer argued that its failure to pay was justified on the grounds that the seller had improperly suspended performance unilaterally and had delivered goods with latent defects.

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5 Article 7.4.8: “(1) The non-performing party is not liable for harm suffered by the aggrieved party to the extent that the harm could have been reduced by the latter party’s taking reasonable steps. (2) The aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the harm.”
6 Article 9:505: “(1) The non-performing party is not liable for loss suffered by the aggrieved party to the extent that the aggrieved party could have reduced the loss by taking reasonable steps. (2) The aggrieved party is entitled to recover any expenses reasonably incurred in attempting to reduce the loss.”
The Court first found that CISG was applicable on the basis of the Belarusian Civil Code, since the applicable law was to be that of the country in which the contract had been concluded, i.e. Belarus, a Contracting State (Art. 1(1)(b) of CISG).

As to the merits, the Court rejected the buyer’s argument that non-payment by the buyer was justified by the seller’s incomplete delivery of the goods. Under Art. 80 of CISG, a party to a contract cannot rely on the other party’s lack of performance when lack of performance is due to its own acts or omissions. In the case at hand, the Court found that since the buyer had failed to pay for a significant amount of the goods already delivered, it could not rely on the seller’s subsequent refusal to deliver additional goods as an excuse for non-performance.

Furthermore, the Court found that suspension of performance by the seller was in accordance with Art. 71 of CISG, which allows for a party unilaterally to suspend performance when it becomes apparent the other party will not fulfil its obligations. Indeed, the buyer had already accumulated a significant amount of debt towards the seller and had continually failed to make the monthly payments agreed upon, hence the seller was entitled unilaterally to suspend delivery of additional goods. The Court also found that the seller had given the buyer proper notice of its intent to suspend performance and there was no evidence that the buyer had given adequate assurance of his performance so that the seller was required to continue with contract performance.

The Court however found the buyer entitled to set off the amount owed to the seller by the warranty discount agreed upon in the contract for delivery of defective goods (2% of the purchase price).

(b) Buyer's failure to take delivery of the goods causing the seller' failure to make delivery

Germany 8 February 1995 Appellate Court München [7 U 1720/94] (Automobiles case)\(^8\)

A German seller and an Italian buyer entered into a contract for the sale of eleven cars at a stated price. The cars were to be delivered by the end of October. About one month after conclusion of the contract, the seller informed the buyer in a subsequent letter of the exact price for each car, option package included. In the same letter, it also informed the buyer that it would deliver the cars during 'July, August, September [or] October'. The buyer replied by sending back the seller's original letter and added in handwriting that it wanted to receive delivery of all cars that were on rush order by 'July or August and at the latest by August 15'. Some days after August 15, the seller informed the buyer that five of the ordered cars were ready for delivery and that the remaining six cars would be available by the beginning of October. By the end of October, the buyer notified the seller that it could not take delivery of the cars at that time due to substantial currency fluctuations and asked the seller to extend the delivery period until the currency situation returned to normal. The seller alleged damages for lost profits as a consequence of the buyer's breach of contract. The buyer commenced an action for restitution of the sum that the seller had obtained by executing a stand-by guarantee and asked for damages, alleging the seller's breach of contract for late delivery.

The Court held that the contract was governed by CISG according to Art. 1(1) (a) of CISG. Also, the Court held that the initial contract had not been modified by the subsequent letters. The seller's first letter constituted an offer for modification of the original contract in accordance with Art. 29 of CISG and required acceptance by the buyer in order to become effective (Art. 18 of CISG). The Court then analysed the buyer's reply. It held that reduction of the time of delivery from 'July, August, September [or] October' to 'July or August and at the latest by August 15' was a substantial modification of the terms of the offer. Therefore, it constituted a counteroffer which the seller had not accepted pursuant to Art. 19 of CISG.

The Court then addressed the issue of the seller's right to damages. It held that the buyer's failure to take delivery of the goods constituted a breach of contract which entitled the seller to damages. However, the buyer did not have to pay any damages because the seller failed to take reasonable measures to mitigate the loss of profit as required by Art. 77 of CISG. Specifically, the Court found that in order to mitigate harm, the seller should have availed itself of its remedies under Art. 61(1) (a) of CISG (i.e. fixing an additional period of time for performance and avoiding the contract) which might have led the buyer to performance. Indeed, in the Court's opinion the remedies available to the seller pursuant to Article 61(1)(a) are particularly warranted here because the buyer in its final reply did not intend to refuse to take delivery but merely sought to avoid the disadvantages of the extreme currency fluctuation. The Court held that the seller's failure to give the buyer the opportunity to perform via reasonable measures must be taken into account in order to calculate the amount of damages. In this respect the seller should be considered to be in the same position as he would have been had performing the contract. Therefore, the Court did not award the seller any damages. The Court then considered the buyer's position: the buyer had the right to avoid the contract because the seller actually did not deliver the goods. This entitled the buyer to restitution of the sum obtained by the seller by executing the stand-by guaranty (Art. 81(2) of CISG).

With respect to the buyer's damage allegation, the Court found that the non-delivery of the goods had been caused by the buyer's failure to take delivery. Therefore, it concluded that the buyer had lost its right to damages pursuant to Art. 80 of CISG.

Finally, the Court determined that according to Art. 84 of CISG the buyer was also entitled to interest on the sum to be refunded. The Court, in interpreting Art. 84 of CISG, applied the statutory interest rate of the seller's place of business (Germany).

(c) Seller's failure to perform its obligation to designate the port of shipment causing the buyer's failure to open a letter of credit

Austria 6 February 1996 Supreme Court (Propane case)⁹

A German and an Austrian company had entered into negotiations for the conclusion of a master contract, without reaching a definitive agreement thereon. Shortly afterwards the same parties entered into a sales contract according to which the German company (the seller) was to deliver propane gas to the Austrian company (the buyer). The buyer specified, inter alia, that the goods were to be exported to Belgium. According to the contract, payment was to be made through


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letter of credit. Thereafter the buyer repeatedly urged the seller to name the shipping port, as it had been contractually agreed. Failing this indication, the buyer could not open the letter of credit and informed the seller thereof. In its reply, the seller notified that its own supplier had not consented to exporting the gas to the Benelux countries, and therefore refused to deliver the gas. The buyer commenced an action to recover damages, including the amount claimed by the customer to which it had already resold the gas. The seller counterclaimed that no contract had been concluded, since contrary to the seller's standard terms the buyer's acceptance was not in writing. Moreover, was not in writing furthermore, that the buyer had not issued the letter of credit.

The Supreme Court upheld the lower courts' finding that the contract was governed by CISG, as the applicable private international law rules led to the law of Austria, a contracting State (Art. 1(1) (b) of CISG). The Court held that an intent pursued by a party during the first phase of negotiation can bind the parties under Art 9 (1) of CISG as far as the other party knows this intent. In the case at hand the seller did not give evidence that the buyer knew the seller’s standard terms or that it knew the seller’s intent to make reference to the master agreement, which was never concluded and was referred to other types of contracts. Therefore, the Court held that the written form was not required for the conclusion of the contract.

The court observed that in accordance with Art. 54 of CISG the buyer's obligations to pay the price included the issuing of the letter of credit. However, the Court held that that the seller could not rely on the buyer's failure to issue the letter of credit as this was due to the fact that the seller did not name, as contractually agreed, the port of origin and the buyer was not obliged to obtain a 'blank' letter of credit. The Court held that the seller does not comply with the obligation to deliver goods which are free from any right or claim of third parties if after the formation of the contract the delivery of goods is made subject to a restriction of export limitations.

The Court found the buyer entitled to recover damages.

(d) Buyer's unjustified refusal to accept the seller's offer to cure a non-conformity causing the seller's failure to cure

**Germany 31 January 1997 Appellate Court Koblenz (Acrylic blankets case)**

A Dutch seller and a German buyer concluded a contract for the sale of different types of textiles (acrylic blankets). Four days after delivery the buyer complained about lack of quantity and non-conformity of the goods. The buyer refused to pay the purchase price also assuming that the seller had breached a previously concluded distributorship agreement between the parties granting the buyer the exclusive right to distribute the textiles in Germany. The seller commenced an action to recover full payment and the buyer counterclaimed set-off with damages for lack of conformity. The lower Court decided in favor of the seller. The appellate Court confirmed the first instance decision.

As regards the lack of quantity, the Court found that the buyer had not sufficiently specified the nature of the lack of conformity according to Art. 39(1) of CISG since it had not indicated the
type of the lacking blankets. Therefore, it could not declare the contract avoided (Art. 51(1) of CISG) as it had lost the right to rely on a lack of conformity.

The buyer was also not entitled to declare the contract avoided on the basis of a lack of conformity of the goods. The Court stated that the lack of conformity entitles the buyer to declare the contract avoided only when it amounts to a fundamental breach of the contract (Art. 49(1)(a) of CISG). In order to determine the occurrence of a fundamental breach regard is to be had not only to the nature of the lack of conformity but also to the readiness of the seller to remedy the non-conformity without unreasonable delay and unreasonable inconvenience to the buyer (Art. 48 of CISG). In the case at hand, the Court excluded the presence of a fundamental breach of contract as the buyer had unjustifiably not accepted the seller's offer to remedy the non-conformity by delivering substituting goods, in accordance with Art. 48 of CISG. This result was not precluded by the remark that, pursuant to Art. 48(1) of CISG, the right to avoidance prevails over the seller's right to cure, since this prevalence is only effective in case of a fundamental breach of contract, an event which was excluded by the Court.

Following the Court's reasoning, the buyer was also not entitled to reduce the price as it had refused to accept performance by the seller in accordance with Art. 48 of CISG (Art. 50 of CISG).

The question whether the parties had concluded a distribution agreement remained undecided. In the Court's opinion, although the breach of a secondary obligation under the contract, like that deriving from an exclusive distribution agreement, may amount to a fundamental breach giving a right to avoid the contract (Art. 49(1)(a) of CISG), the buyer had nonetheless not declared the contract avoided. In particular, a declaration of the buyer could not be interpreted as a declaration of avoidance as the subsequent conduct of the buyer was incompatible with such an interpretation (Art. 8(3) of CISG). In any case, however, the buyer had lost the right to declare the contract avoided as it had not done so within a reasonable time after it knew of the breach (Art. 49(2)(b)(i) of CISG).

As regards the buyer's claim for damages (loss of profits) deriving from the delivery of non-conforming goods, the Court stated that, pursuant to Art. 80 CISG, the buyer had lost the right to damages as it had hindered the seller's cure of non-conformity.

(c) Buyer's failure to adhere to operating instructions causing a breakdown of the delivered equipment

Tribunal of International Commercial Arbitration on the Russian Federation Chamber of Commerce and Industry, 29 December 2004

The [Buyer] brought an action to the Tribunal of International Commercial Arbitration on the Russian Chamber of Commerce and Industry [hereinafter Tribunal] and the Respondent [Seller] does not call into question the competence of the Tribunal but has raised a question only as to whether these proceedings are premature by virtue of a Joint Commission that was to be established by the parties. Due to the above, an inaccuracy in the name of the arbitration tribunal in the arbitration clause of the contract does not preclude consideration of the case by the Tribunal.

The Bilateral Commission that was called for in the contract could not determine a cause-and-effect relation between the breakdown of the contract equipment during the guarantee period and the [Buyer]'s breach of service conditions. As a result, the parties are jointly liable and jointly have to pay compensation for the damages caused by the breakdown of the equipment. The allocation of damages by the Tribunal between the parties was governed by the principle of justice and fairness.

The action was brought by [Buyer], a Ukrainian organization, against [Seller], a Russian organization, as a result of the breakdown of equipment during the guarantee period provided by the [Seller] according to their contract for the international sale of goods concluded on 29 December 1997. Since the Bilateral Commission, which was established according to the contract, concluded that the broken-down equipment can no longer be operational, the [Buyer] claimed for damages incurred and legal costs.

The [Seller] contested the [Buyer]'s claims. The [Seller] referred to the fact that the Bilateral Commission had established that the [Buyer] had failed to adhere to the operating instructions. The [Seller] declares that the [Buyer]'s claims are not justified as there are no conditions provided for by the contract that give a rise to [Seller]'s liability under quality guarantee. The [Seller] also alleges that the case should not be considered by the Tribunal as the contract stipulated the establishment of a Joint Commission in the event the [Seller] contests the [Buyer]'s complaint. However, such a Commission was not established. As a result, although the [Seller] agrees with the Tribunal's competence to consider this case, though only with regard to the establishment of this Commission.

The [Buyer] submitted its objections to the [Seller]'s position. The [Buyer] argued that failure to adhere to the operational instructions could not be a cause of the breakdown of the equipment. In addition, the [Buyer]'s representative noted that, according to Article 476(2) of the Civil Code of the Russian Federation [hereinafter - CCRF], the burden of proof that there is no liability under the quality guarantee rests with the [Seller]. The [Buyer] stated that the [Seller] had not responded to the complaint of the [Buyer] and to [Buyer]'s proposal concerning the establishment of the Joint Commission. The [Buyer] also noted that the Statement of the Bilateral Commission had not determined the cause of the breakdown of the equipment.

Taking into account the above, the Tribunal states that pursuant to Articles 35-36, 45 and 74 of the CISG, Articles 475, 476 of the CCRF and sections 11-13 of the contract, the [Seller] must pay damages to the [Buyer]. At the same time, the Tribunal states that due to the fact that the parties failed to determine the cause of the breakdown of the equipment, both of them should suffer a financial burden resulting from that. The greater share of the liability is imposed on the [Seller] since it, as the supplier, had to take into account the specificity of the equipment and should have been more punctilious and demanding in following the provisions stipulated in the contract, in determining the cause of the breakdown of the equipment and in preventing further violations.

Taking the above circumstances into account and pursuant to the principle of justice and fairness, the Tribunal rules that the [Buyer] is entitled to reimbursement from the [Seller] of three-quarters of the losses suffered. The rest of the losses are to be covered by the [Buyer] itself.
[Buyer]'s claim for recovery from the [Seller] of the arbitration fee shall be granted in proportion to the amount of claims granted, according to section 6(2) of the Regulations on Arbitration Expenses and Fees (Supplement to the Rules of Tribunal).

(f) Seller's repudiation of future delivery obligations causing the buyer's failure to pay for some prior deliveries

*Switzerland 31 May 1996 Zürich Arbitration proceeding (Soinco v. NKAP)*

From 1991 a Russian seller (a governmental agency) entered into a number of contracts with buyers having their places of business in Argentina and Hungary for the sale of raw aluminum. Deliveries were duly performed until the seller was taken over by a Russian private company, which immediately declared its unwillingness to make any further delivery. In a subsequent exchange of correspondence the buyers warned they would suffer substantial prejudices if the metal would not be supplied in a timely manner; the seller, in addition to confirming the provisional stop of deliveries, issued a bill for a certain amount of US dollars and urged the buyers to pay accordingly. In view of the seller's refusal to enter into renegotiations in order to amicably settle the dispute, the buyers brought arbitral proceedings claiming delivery of the quantity of aluminum provided for in the contracts and damages arising out of late shipment; the seller pleaded the defense that the buyers' delay in paying the price of past deliveries amounted to a fundamental breach of their contractual obligations which justified its refusal to perform.

In the absence of a contractual choice of law by the parties, the Arbitral Tribunal (despite the fact that both parties had their place of business in contracting States), decided to apply Russian law to the merits of the dispute. However, since CISG applies in Russian law to international contracts for the sale of goods concluded on or after September 1st 1991, it concluded for the application of CISG to all substantive issues falling within its scope of application, insofar the parties had not departed from its provisions (Art. 6 CISG).

As to the merits, the Arbitral Tribunal held that the seller's interruption of deliveries amounted to a fundamental breach of its obligations (Art. 30 of CISG), more precisely an anticipatory repudiation of an installment contract (Arts. 49, 72 and 73 of CISG), which entitled the buyers to declare the contract avoided without their having to fix an additional time for performance.

With respect to the seller's defense that his refusal to perform the remaining deliveries was justified by a buyers' fundamental breach (Art. 81 of CISG) of their payment obligations under an installment contract (Art. 73 (2) of CISG), the Arbitral Tribunal held that there was no indication that the buyers were unable or unwilling to perform their payment obligations (Art. 71 (1) (a) of CISG), nor that they had committed an anticipatory breach of contract (Art. 72 of CISG), and that in any case the seller had failed to fix an additional time for payment (Art. 64 (1) (b) of CISG).

The Arbitral Tribunal further pointed out that the seller's refusal to enter into renegotiations with the buyers ran counter to the parties' previous course of dealing, according to which the parties were used to entering into renegotiations to solve their dispute.

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Then the Arbitral Tribunal, after stating that pursuant to CISG a judgment for specific performance can only be entered if the Court would do so under its own law, applying Russian law rejected such claim.

Finally, the Arbitral Tribunal awarded the buyers damages for their actual loss (including additional finances and stocking expenses which resulted from the interruption of deliveries), in accordance with Art. 74 of CISG. In carrying out its analysis, the Arbitral Tribunal observed that the amount claimed by the buyers should be reduced to the extent necessary to take into account the increase in the price of the goods which would arguably have occurred had the remaining deliveries been performed. In fact, it was true that the contracts concluded with the governmental agency granted the buyers preferential prices (i.e. below the average world market price), but they also provided for a periodic renegotiation (every three months) of such prices. The buyers should therefore have foreseen, at the time of the conclusion of the contract, forthcoming increases in the contractual prices.

3. Conclusions

The primary purpose of this paper was to provide an overview of the reasonableness of the measures aimed at mitigation of the harm through the most frequent cases that in practice causes the situation of the need to provide a solution for mitigating the harm. These cases from the practice were accompanied by court decisions and arbitral awards that have been judged and settled the disputes of these cases. The analysis of judgements and awards proves that there can be no strict rule providing for situations, where certain mitigation measures are expected. As such, the duty to mitigate is a fundamental principle of the lex mercatoria and is also one of the most applied principles in the legal systems of different states and in international arbitration. Courts and arbitration tribunals generally assume that the duty to mitigate is a part of general trade usage. Therefore, the failure to mitigate will not affect the injured party's claim for other remedies. The only exception is said to be the case where it was reasonable to expect the injured party to carry out certain actions, for example, in the form of avoidance of the contract or of the conclusion of a substitute transaction, in order to mitigate the harm.

References