

THE LEGALITY OF 'DISGORGEMENT OF PROFITS' IN CASE OF A BREACH UNDER CISG*

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Abstract

The situation where an aggrieved party wants to claim damages does not always benefit their position to ask for compensation. For instance, in some cases, the aggrieved party's loss is hard – and even impossible to be calculated. When an aggrieved party wants to claim damages, CISG requires the damages to be equal to the sum of the loss. However, when the loss itself is hard to be calculated, how would the aggrieved party claim for their damages? This is where the disgorgement of profits comes into play.

The disgorgement of profits is a method of calculating damages by allowing the aggrieved party to strip off the profits gained by the breaching party. Even though CISG has never mention anything about the calculation method, some scholars argue that disgorgement of profits cannot be applied due to its punitive nature. This paper will discuss about the legality of disgorgement of profits in theory and current practice to be applied under CISG in case of a breach.

Intisari

Situasi dimana pihak yang dirugikan ingin menuntut ganti rugi tidak selalu menguntungkan posisi mereka untuk meminta kompensasi. Misalnya, dalam beberapa kasus, kerugian pihak yang dirugikan sulit — dan bahkan mustahil untuk dihitung. Ketika pihak yang dirugikan ingin menuntut ganti rugi, CISG mengharuskan jumlah ganti rugi setara dengan jumlah yang dirugikan. Namun, ketika jumlah kerugian itu sendiri sulit untuk dihitung, bagaimana cara pihak yang dirugikan menuntut ganti rugi? Disinilah disgorgement of profits berperan sebagai cara untuk mengatasi masalah tersebut.

Disgorgement of profits adalah metode penghitungan kerugian yang memungkinkan untuk pihak yang dirugikan untuk menanggalkan keuntungan yang diperoleh oleh pihak yang merugikan atau melanggar. Meskipun CISG tidak pernah menyebutkan apa-apa tentang metode perhitungan kerugian, beberapa pakar hukum berpendapat bahwa disgorgement of profits tidak dapat diterapkan karena bersifat menghukum bukan mengompensasi. Makalah ini akan membahas tentang legalitas disgorgement of profits dalam teori dan praktek saat ini untuk diterapkan dibawah CISG dalam kasus pelanggaran kontrak.

Keywords: Disgorgement, CISG, damages, punitive, compensatory

Kata Kunci: Disgorgement, CISG, ganti rugi, menghukum, kompensasi

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A. Introduction

The United Nations Convention on Contracts for the International Sale of Goods ("CISG") is an international agreement, which forms a unification of international sales law (Schwenzer). This convention regulates a uniform law that upholds equal rights for both seller and buyer (Kelly). In case of a breach, CISG protects the right of the buyer where the aggrieved party can claim for damages based on a breach committed by the breaching party.

Article 45 of CISG stipulates "If the seller fails to perform any of his obligations under the contract or this Convention, the buyer may claim damages as provided by Article 74 to 77". However, Article 74 CISG does not define damages exhaustively. It does not provide specific guidelines for calculating damages (*CISG Commentary*). The CISG only explicitly states that the damages that can be awarded only consist of a sum equal to the loss, including loss of profit as a consequence of the breach (Art. 74 CISG). In practice, sometimes the loss suffered by the aggrieved party is often hard to calculate and even impossible to be calculated. For example, loss of goodwill or loss of reputation that is impossible be calculated. These circumstances made it impossible for the buyer to claim their right under the Convention.

By definition, disgorgement of profits principle is a calculation method in awarding damages to an aggrieved by stripping off the breaching party's gains. The gains made by breaching party are seen to be reflecting the loss suffered by the aggrieved party (*Schwenzer/Hachem in Saidov/Cunnington*). This principle would answer the above situation where the loss is hard or even impossible to be calculated. However, up until today, even though this principle has been widely used under national jurisdiction, the legality of

disgorgement of profits under CISG is still in question. This is due to the clash of scholarly opinion upon the purpose of disgorgement of profits. Primarily such an award given through disgorgement of profit aims to strip the gain received by the party in breach, thereby deterring future breaches, making this principle punitive in nature (*Barnett*). On the contrary, the drafter of CISG – Ingeborg Schwenzer, suggests that such an award serves a compensatory purpose (*Schwenzer*). That is why up until today the legality of disgorgement of profits in CISG is still in question.

B. Awarding Damages Under Article 74 CISG

Under CISG, in the event of a breach, a buyer is entitled to claim damages if the seller fails to perform any of its obligations as provided in Arts. 74 to 77. The principle stipulated in Art. 74 is 'brief but powerful' (*Schwenzer*), which aims to fully compensate the aggrieved party for its loss and thus it has a compensatory nature (*CISG Ac. Op.*). The plain wording of Art. 74 CISG is as follows:

"Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract." (Emphasis added).

This article should be interpreted liberally (*Schwenzer*), as it gives the dispute settlement body the authority to determine the aggrieved party's "loss suffered ... as a

consequence of the breach" based on the circumstances of the particular case (*CISG Ac. Op.*). Art. 74 only limit the granting of the award with two requirements. The first requirement is that the loss should be a consequence of the breach. Second, it should meet the foreseeability element. It does not limit on how the dispute settlement body would grant such calculation of loss. However, according to Art 74 itself, the compensation for the loss that has to be given to the breaching party has to be "sum equal to the loss". This means that the aggrieved party could not get more than they are supposed to get. The rationale behind is due to the need to prevent the aggrieved party to enrich themselves. Although a claim for breaching party's gain is also to avoid unjust enrichment (*McCamus*), in order to avoid the unjust enrichment, the aggrieved party has to calculate the loss that they suffered (*Lookofsky*).

In some cases, the loss could be very difficult and even impossible to calculate, such difficulties arise when goods are non-substitutable, such as loss of reputation because the non substitutability itself is connected with the fact that there is no telling how much money would satisfy the aggrieved party itself (*Thel/Siegelman*). Not only that, for example, market price is often difficult to calculate because it can change anytime depends on the situation. As the market price is difficult to calculate, the profits made by the breaching party can be taken into account in calculating the minimum loss of the aggrieved party (*Schwenzer/Hachem in Saidov/Cunnington*). When there is a difficulty on calculating damages, disgorgement of profit could be the most viable solution in awarding such damages, as the profit that the breaching party gains from its breach of contract could help measure the aggrieved party's loss where it is difficult to place (*Saidov*).

In some cases, punitive nature of disgorgement of profit does not suit the compensatory nature of Article 74 CISG (*Plastic Carpets Case*). The disgorgement of profits is a gain-based calculation of damages. It allows the aggrieved party to refer to the profits the seller earned with a third party to calculate its own damage (*Schwenzer*). In other words, the concept of disgorgement of profit is to put the *breaching party* in the same position as if the breach did not occur. This principle has the same meaning as the performance interest principle under Art 74 CISG. Moreover, this principle focuses on the breaching party's gain instead of the aggrieved party's loss. Whereas the concept of Art. 74 CISG is to put the *aggrieved party* in the same position as if the breach did not occur (*CISG Ac. Op. No. 6*).

C. The current practice of awarding damages based on Disgorgement of Profits

Disgorgement of profits is commonly recognized in various domestic legal systems, as it complies with the purposes of CISG that is certainty and uniformity. In status quo, there is no precedent yet that an award is granted based on a disgorgement of profits in CISG. However, disgorgement of profits can be found as a general practice in some countries, especially countries with civil law jurisdiction. As a matter of fact, disgorgement principle is increasingly recognized today in cases where courts award damages for a breach of contract (*Robertson; Dubai Aluminum Co Ltd. v. Salaam Hendrix v. PPX.*). Even national jurisdictions have widely varying views on disgorgement principle (*Scalise*).

The current practice of awarding damages based on disgorgement of profits has been done in several countries, such as Israel, Ireland, Netherlands, and England. For example, in *Adras* case, disgorgement

was awarded for breach of contract on the basis of unjust enrichment. The case was awarded on the basis of domestic Israeli law (*Adras Chmorey Binyan v Harlow & Jones GmbH*). Disgorgement of profit is also a remedy recognized in tort in some jurisdictions (Schwenzer). Irish civil law also has allowed the application of disgorgement of profits that arises from breach of contract for many years (*Hondjus and Jansen*), especially in the case of contractual wrongs. There is a precedent where the disgorgement of profits awarded because the defendant acted in bad faith. The bad faith constituted on that case was reflected on the action of the defendant for achieving gain from his wrongdoing (*Hickey v Roches stores*). Further, the disgorgement of profit is also applied in the Dutch Civil Code, where it is used as a means of quantifying the damages to which an aggrieved party (*Waeyen-Scheers v Naus*). This principle has also been affirmed in *Attorney General v. Blake*, where disgorgement was awarded to the aggrieved party, noting that the defendant's profit providing the measure of a loss was difficult to measure (*Attorney General v Blake*).

Seeing the wide practice of awarding damages based on disgorgement of profits, it does not close the possibility of disgorgement of profit to be applied under CISG. The reason is because CISG is an international convention, which serves as a form of unification of law. Disregarding the possibility of disgorgement would undermine the Convention in the core area of damages, as domestic remedies applied precisely in the cases for which the CISG was originally designed (*Schwenzer/Hachem in Saidov/ Cunnington*). Moreover, within some circumstances, it is also possible to claim loss based on the breaching party's profits (*Schwenzer*). Therefore, seeing the wide practice of

disgorgement of profits, it does not preclude the possibility of this principle to be implemented under CISG.

D. Reflection of CISG in Disgorgement of Profits

i. Awarding Damages by Disgorgement of Profits is in line with the full compensation principle in CISG

Awarding the gains of the breaching party as measure of damages actually fulfills the purpose of Art. 74 CISG because of two reasons. First, this Article is intended to afford an aggrieved party *compensation*, and awarding gain-based damages falls within the scope of compensatory damages. Based on a commentary on Art. 74 CISG, a dispute settlement body may, when assessing damages, also consider benefits gained by the breaching party from the breach of contract (*Schwenzer and Schlechtriem*). Especially in cases where the party's loss is not adequate to compensate the party and the aggrieved party cannot calculate the amount of loss, it could be justified to rely on disgorgement of profits to achieve the result of full compensation (*Saidov*).

Commentators of CISG, Schwenzer and Hachem, also specifically state, "The gains by the breaching party can easily be viewed as nothing more than a presumption of what the aggrieved party has actually lost." (*Schwenzer and Hachem*). "Thus," they continue, "we are still in the realm of compensatory damages." (*Id.*). Other commentators of CISG have also supported this view (*Schmidt-Ahrendts*). Had the breaching party not breached the contract; they will not gain the profit at the first place. By disgorging the seller's profits to the advantage of the buyer, it compensates the damages that the buyer suffered due to the breach of contract (*Saidov*). That is why the disgorgement of profits falls within the

compensatory nature instead of punitive. Even if it is considered as punitive damages, in some circumstances, especially in the event of an international breach committed in bad faith, a court or tribunal should allow taking a punitive punishment when awarding damages (*Schwenzer and Hachem*).

ii. Awarding Damages by Disgorgement of Profits acts as a 'gap filler' in CISG

The application of disgorgement of profits under the CISG is necessary in order to fill the gap in the CISG. The Secretariat Commentary on the 1978 Draft of the CISG, the closest text to an official commentary, noted that the CISG does not specify the method for determining loss. Instead, "The court or arbitral dispute settlement body must calculate that loss in the manner which is best suited to the circumstances." (*CISG Commentary*). In addition, disgorgement of profits has only become a prominent remedy since the drafting of the CISG. Allowing its silence to exclude the availability of a remedy would not be in line with the drafter's intention (*Schwenzer and Spagnolo*). Thus, it means that CISG leaves the interpretation of awarding damages to the discretion of the dispute settlement body.

Scholar Schmidt-Ahrendts stated that,

"One of the main goals of the CISG is to provide parties with a uniform and complete set of rules governing international sales contracts. This purpose would be severely undermined if, although a contract is governed by the CISG, too many issues would still have to be solved by applying national law."

Without the guide of interpretation on calculating damages such as disgorgement of profits, some jurisdictions will allow for a claim for awarding gain-based damages

while others will not. Consequently, it will undermine the idea of uniformity on which the CISG, particularly Art. 74 CISG, are based (*Ahrendts*).

Art. 7 (1) CISG provides that when interpreting the CISG, courts must give regard to its international character, the need to promote the uniformity in its application and the observance of good faith. In order to do so, the courts must interpret the Convention autonomously. This means that the Convention must be applied and interpreted exclusively on its own terms, having regard to the principles of the Convention and Convention-related decisions in overseas jurisdiction (*CISG Digest; XX Cucine S.p.A. v. Rosda Nigeria Limited*).

In regards to the interpretation, Art. 7(2) CISG provides that "Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principle [...]". Internal gaps in the CISG are subject to be settled in conformity with its underlying principles (*Art. 7(2) CISG*) this can be done through analogy (*Bianca and Bonell*), or by applying principles. Since the Convention is silent on the calculation method, through general principle, the disgorgement principle is applicable in awarding the aggrieved party's loss. Therefore the application of disgorgement of profits can be constituted as 'gap filler' in the Convention as it interprets the calculation method of Art. 74 CISG.

E. Disgorgement of profits accords with the general principles under CISG

As has been already explained above, under article 7 (2) of CISG, if something is not govern by the Convention then it can be settled using general principles. CISG embraces many general principles and one of them is good faith, which is embodied in Article 7 CISG,

including Art. 74 (*Bianca and Bonell*). Private law should not focus on financial but also good faith and fairness (*Scmidt-Ahrendts*). Even though minority of scholars opined that good faith is no more than a general interpretive principle, the majority view suggest that Art. 7 are a substantive criterion of the CISG, with broad practical application (*Id.*).

In order to promote the observance of good faith in international trade, it is necessary to fully compensate the injured party and to put the breaching party to the position it should have been by summoning the breaching party to surrender the ill-gotten benefits. In relation to that, CISG must not limit the focus of remedial provisions to the compensation of financial losses, but seek to promote good faith and fairness, prevention of unlawful and unethical behavior, and the allocation of risks and gains in a fair and just manner (*Schwenzer and Leisinger*).

The obligation to act in good faith should evolve with modern development in order for CISG to remain relevant in current commercial contexts (*Kroll, et.al.*). Disgorgement of profits is a suitable remedy especially if the party in breach acted in bad faith, because disgorging the profits is a logical interpretation by the principle that a wrongdoer shall not profit from its wrong doing (*McCamus, Dagan*). Allowing the application of disgorgement of profits obtained through breach of contract in bad faith promotes compliance of good faith, as referred in CISG (*Schlechtriem*). Seeing that the application of disgorgement of profits is in line with the good faith principle embodied in CISG, it affirms the legality of such principle in awarding damages under CISG.

Not only good faith, CISG also embraces general principle of *pacta sunt servanda* and the performance principle. These principles could be seen in Art. 46,

which means that the contract should be obeyed and gives the right for an aggrieved party to require specific performance to the breaching party in order to fulfill its contractual obligation (*Vanto*). The purpose of the law of damages is the evolution of the pure compensation of the loss to a precaution mechanism in order to support *pacta sunt servanda* (*Schwenzer/Hachem in Saidov/Cunnington*). One of the ways is by disgorgement of profits because permitting this claim is very important for the parties to fulfill their obligations under the contract as based on the general principle of the CISG that is *pacta sunt servanda* (*Magnus*).

Moreover, the rationale behind disgorgement lies in the connection with specific performance [*Cunnington, Waddams*], because performance principle is also allows disgorgement of profits (*Schwenzer in Schlechtriem/ Schwenzer Art 74*). For example as seen in the cases of *Jarvis v Swan Tours, Ruxley Electronics and Construction Ltd. V Forsyth, and also Farley v Skinner*. Those cases specifically provide an application of performance principle. These principles should be applied when interpreting CISG in order to meet demands as the promotion of contractual rights (*Schwenzer/Hachem in Saidov/Cunnington*). Thus, according to general principles that CISG recognized, it still possible to use disgorgement of profits.

F. Conclusion

In status quo, the absence of calculation method to award an aggrieved party's damages leaves a range of interpretations in awarding damages under CISG. One of the calculation methods is a doctrine called disgorgement of profits. The legality of disgorgement of profits in awarding damages under CISG is still debated among scholars. One believes that the punitive nature of disgorgement of

profit does not suit the compensatory nature of CISG (*Plastic Carpets Case*). On the other hand, awarding an aggrieved party through disgorgement of profits can actually reflect the purpose of Art. 74 CISG, which is to compensate the aggrieved party. Theoretically, through the interpretation of general principle (Art. 7(2) CISG),

disgorgement of profits can be applied under the ambit of CISG. Even though there is no precedent on disgorgement of profits to be used under CISG yet, there is a possibility that disgorgement of profits will be used under the application of Art. 74 CISG and Art. 7(1) as a gap filler of the Convention in the future practice.

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