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Article abstract

Notre collaborateur étudie, sous l'angle du droit comparé, le risque d'inflation, en abordant les clauses de maintien de la valeur économique dans un contrat international. En effet, Me Dubé passe d'abord en revue certaines législations prévoyant le prix de vente dans un contrat : le Code civil français, le Code civil du Québec, la *Common Law* au Canada, au Royaume-Uni et aux États-Unis. Puis, l'auteur suggère des clauses de maintien de la valeur en période inflationniste qui se révèlent fort intéressantes, notamment les clauses dites « *hardship clauses* », « *stabilization clauses* », « *commodity clauses* » et « *index clauses* ». À n'en pas douter, le meilleur remède aux dangers de l'inflation dans les contrats internationaux réside dans la formulation de dispositions contractuelles appropriées aux circonstances en cause.

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Value Maintenance in International Transactions : The Inflation Risk[1]

by

Georges Dubé[2]

Notre collaborateur étudie, sous l'angle du droit comparé, le risque d'inflation, en abordant les clauses de maintien de la valeur économique dans un contrat international.

En effet, Me Dubé passe d'abord en revue certaines législations prévoyant le prix de vente dans un contrat : le Code civil français, le Code civil du Québec, la Common Law *au Canada, au Royaume-Uni et aux États-Unis.*

Puis, l'auteur suggère des clauses de maintien de la valeur en période inflationniste qui se révèlent fort intéressantes, notamment les clauses dites "hardship clauses", "stabilization clauses", "commodity clauses" *et* "index clauses". *À n'en pas douter, le meilleur remède aux dangers de l'inflation dans les contrats internationaux réside dans la formulation de dispositions contractuelles appropriées aux circonstances en cause.*

The price to be paid for goods sold or services rendered in international transactions gives rise to a number of risks, one of which results from the effect of inflation.

If price levels rise unexpectedly after an agreement has been reached, the buyer gains at the expense of the seller, all other things

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(1) This article is based on a presentation made in Ottawa on October 18, 1989 to a conference on "The Management of Risks in International Business" sponsored by the University of Ottawa, the Canadian Export Association and the Centre for Trade Policy and Law.

(2) Georges Dubé is a partner with the law firm of Lavery, O'Brien in Montreal and formerly Vice President, General Counsel and Corporate Secretary of NOVA Corporation of Alberta in Calgary.

being equal, since the buyer will be required to pay the same number of cheaper units of currency to discharge his obligation to the seller.

This text will focus on alerting practitioners, as well as persons involved in business, to some of the potential problems frequently encountered in trying to control the inflation risk in international transactions, and on offering some practical suggestions to help solve those problems.

Most legal systems adhere to the principle of "nominalism" to govern the payment of the price under a contract. That principle can be articulated in the following manner: the value of money is presumed to be constant for the purpose of discharging legal obligations. In other words, the amount to be paid in the currency specified in the contract remains the same even if the price of the product or service changes between the time of entering into the contract and the time the payment is made. Therefore, inflation can have a marked effect on payment obligations whether the contract is considered to be international or domestic.

Before discussing clauses directed at reducing the risks resulting from inflation, it is useful to consider, briefly and in a summary manner, certain principles of contract law as they relate to price.

The Price in a Contract

The words *international contract* confer an aura of glamour and a shade of mystery to a transaction. In fact, one is dealing with a contract between parties in a Canadian province or territory and parties in a foreign state such as one of the United States, England, France, Singapore or Japan, or, perhaps, a Canadian dealing from a foreign base with a party in yet another country. It therefore becomes a matter of determining the province or the state or the country which has jurisdiction over the contract. It is necessary to identify the law or laws which govern the contract or various aspects of it. Such questions are not answerable by reference to a general global law of contract unless the parties fall within the ambit of a convention such as the Convention on Contracts for the International Sale of Goods (CISG). Generally speaking, "international contracts" are matters for the rules of conflict of laws or private international law.

The express or implicit fixing or making provision for determining the price in a contract is an area where the theories of the

civil law system do not always converge with those developed in the common law system. Scholars have long debated the comparative merits of both theories. It is frequently said that there appears to be enough commonality to make unification possible but not enough diversity to make international unification desirable. An overview of the requirements in certain jurisdictions with which we are more familiar will serve to illustrate the situation.

France

En France, le Code civil[3] prévoit l'obligation pour les parties de fixer le prix de vente. Il s'agit d'une condition de formation du contrat qui, si elle n'est pas respectée, est sanctionnée par la nullité du contrat. La nécessité de la détermination du prix dans le contrat ne s'oppose pas à ce que le prix soit fixé d'après une clause d'échelle mobile pourvu que cette clause satisfasse à la réglementation administrative. Si le Code exige que le prix soit déterminé, la jurisprudence en assouplit la rigueur, en acceptant que le prix soit déterminable. Il n'est donc pas nécessaire que le montant du prix soit fixé dans le contrat d'une manière absolue ; il suffit qu'il soit susceptible de l'être par un procédé choisi dès l'origine et indépendant de la volonté ultérieure de l'une ou l'autre des parties.

Il y a lieu de noter, en outre, que le Code civil[4] prévoit que les parties, au lieu de déterminer elles-mêmes le prix, peuvent convenir que celui-ci sera fixé par un tiers. Toutefois, si le tiers ne veut ou ne peut fixer le prix, il n'y a pas de contrat de vente.

Québec

Au Québec, le Code civil[5] prévoit que le prix sur lequel porte l'objet de l'obligation de l'acheteur est un élément essentiel du contrat de vente. Là où il n'y a pas de prix et où il n'est pas possible de le déterminer, il n'y a pas de contrat de vente. Le contrat doit contenir des éléments qui permettent de déterminer le prix au moment de son échéance, sans influence possible de la volonté postérieure des parties. Les dispositions de l'article 1592 du Code civil français ne se retrou-

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[3] Article 1591 du Code civil français.

[4] Article 1592 du Code civil français.

[5] Articles 1472 et 1522 C.c.

vent pas dans le Code civil québécois ; le Rapport des codificateurs en 1865 ne donne aucune indication de la raison pour laquelle cet article n'a pas été retenu.

Il est intéressant de noter que le Projet de code civil présenté en 1977 par l'Office de révision du Code civil met de l'avant une solution fort intéressante sur le sujet en question. En effet, on y propose l'addition du texte suivant au Code civil :[6]

> *« Lorsque le prix n'est pas déterminé ni déterminable par le contrat, l'acheteur doit payer le prix généralement exigé dans des circonstances semblables. »*

Dans les commentaires[7] *sur cette nouvelle règle, on précise qu'elle vise à valider la vente lorsque la convention elle-même ne permet pas de déterminer le prix, et qu'ainsi la loi présume que les parties ont entendu s'en tenir au prix courant en pareilles circonstances. La source de cette recommandation ne provient pas de la jurisprudence, mais plutôt de législations étrangères tels le Code civil de la République fédérale d'Allemagne, le Code civil éthiopien, le Code suisse des obligations, la Conférence diplomatique sur l'unification du droit en matière de la vente internationale et le* Uniform Commercial Code *américain.*

Common Law Jurisdictions

In common law jurisdictions, the basic problem has been to determine the price when the contract is silent on the subject or the parties have agreed that the price shall be fixed in the future. Where the contract is silent as to price, the court will fix a reasonable price and what constitutes a reasonable price is a question of fact dependent on the circumstances of each particular case. This rule has been codified in statutes dealing with the sale of goods in all common law provinces and territories in Canada and in the United Kingdom.

However, the situation where the price has been expressly reserved for agreement in the future by the parties, has provoked much litigation and differences of judicial opinion in England and Canada. Essentially, it appears that the courts are less willing to imply a rea-

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(6) Projet de code civil, livre V, article 386.

(7) Rapport sur le code civil du Québec – Commentaires, volume II, tome 2, page 708, article 386.

sonable price where the parties have expressed an intention to agree on a price in the future. In other words, if the parties say nothing about price, there is likely to be an enforceable contract ; if the parties say that they will agree on the price, there may not be an enforceable contract.

United States

In the United States, the Uniform Commercial Code does not provide for the failure of a contract because of indefiniteness even though one or more terms have been left open "if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy."[8] Moreover, the Code spells out the implications with respect to the specific case of price.[9] In essence, the Code supports the view that commercial contracts should be upheld whenever possible if the contract conforms with the intention of the parties.

Contracts for the International Sale of Goods

In 1980, a diplomatic conference sponsored by the United Nations adopted the Convention on Contracts for the International Sale of Goods (CISG). The Convention is frequently referred to as the Vienna Convention or the International Sales Convention. As a general effect of the Convention, a state which becomes a party to the Convention will have two sales laws : a domestic sales law and the Convention. The courts of the contracting state will no longer have to apply the numerous different foreign sales laws that otherwise might be applied by virtue of choice-of-law rule. The provisions of the Convention which deal with price provide an interesting illustration of a compromise effected between principles of civil law and of common law. An offer is defined as "a proposal for concluding a contract addressed to one or more specific persons. . . if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance."[10] A proposal is "sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity and the price."[11] The requirement

[8] Uniform Commercial Code § 2-204 (3).

[9] Uniform Commercial Code § 2-204 (5).

[10] Article 14 – United Nations Convention on Contracts for the International Sale of Goods.

[11] *Ibid.*

that provision be made for determining the price appears to be drawn from the Civil Code of France and the civil law system. According to Professor Jacob S. Ziegel who was a member of the Canadian delegation to the United Nations diplomatic conference in Vienna at which the Sales Convention was adopted, this article "was the subject of heated debate," and according to him, "an uneasy compromise was eventually reached, not by amending article 14 but by inserting a new article 55"[12] which reads as follows :

> "Where a contract has been validly concluded but does not expressly or implicitly fix or make provision for determining the price, the parties are considered, in the absence of any indication to the contrary, to have impliedly made reference to the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned."

It is most important for Canadian buyers and sellers to remember that, even if Canada has not acceded to the Convention, their contractual relationships may be governed by its provisions. This situation results from the fact that the Convention applies to contracts of sale where the contracting parties have their places of business in different contracting states who have ratified or acceded to the Convention, or, if only one of the parties is in a contracting state, where the rules of private international law lead to the application of the law of the contracting state.

Assume a sales contract concluded after January 1988 between a Canadian merchant and a foreign merchant where the place of business of the foreign merchant is in a state which has acceded to the Convention. Even if Canada has not acceded to the Convention there is a substantial likelihood, if not certainty, that the foreign court will apply the provisions of the Convention in the event the court finds that its law is the proper law of the contract. The court may reach the same conclusion in the event the parties have expressly designated the law of that state as the proper law of the contract. The same result may occur in the event the dispute is litigated in Canada and the Canadian court determines that the proper law of the contract is the law of the foreign state.

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[12] Ziegel, "The Vienna International Sales Convention" in J.S. Ziegel and W.C. Graham, *New Dimensions in International Trade : A Canadian Perspective*, 1982, p. 42.

Protection from Inflation

Let us now briefly explore the techniques by which lawyers can attempt to prevent inflation from distorting the contractual obligations of their clients.

It is necessary to bear in mind at the outset that contractual provisions concerning price revision as a result of changed economic circumstances are mandatorily regulated under some legal systems. Contracting parties should always examine whether a price revision clause is permitted under the law of the country of each party and under the law of the contract. In some countries, limitations on price revision clauses or on escalation clauses exist where the purchaser or seller of the goods or services is the government itself or one of its departments or agencies.

Avoidance of Certain Contracts

The most straightforward response to a high inflation rate is the avoidance of long-term and fixed-price contracts. The manufacturer who sells a quantity of shelf items for delivery and payment in the very near future will usually specify a single firm price. However, when the products have to be manufactured and will not be delivered immediately, manufacturers and suppliers will likely attempt to take orders on the basis of "price in effect at the time of delivery." For the reasons discussed earlier, it is prudent under such circumstances that the price be set by reference to a readily identifiable standard which is not dependent on the will or the actions of the manufacturer or the supplier or of the purchaser. A closely related element when dealing with custom manufactured products and high inflation is for the manufacturer to require frequent and substantial progress payments to cover the build-up in costs.

The extent to which all or part of the risk of inflation can be shifted in this manner depends on the relative bargaining positions of the parties. To purchase for a price which is actually not yet known in dollars and cents is clearly less than satisfactory from the point of view of the purchaser of the products. The response of the purchaser, in turn, will likely be to withhold advance orders. The manufacturer or the supplier then sees his planning for production and delivery scheduling jeopardized.

A compromise sometimes results from the ensuing bargaining process in which the manufacturer or the supplier agrees to accept a fixed-price over a given period of time provided his costs of production do not rise beyond a given level. Any increase in costs beyond the stipulated level will be passed on to the purchaser of the products, or shared between the parties. The reverse situation is also a common form of compromise. The purchaser agrees to pay for cost increases up to a fixed level and any increase beyond that level is paid for by the manufacturer or supplier, or shared between the parties.

560 *"Guesstimates" and Hardship Clauses*

A common response, but a rather unsophisticated and unsatisfactory one, to a high inflation rate, is for the parties to build into their contract, either explicitly or implicitly, their best guess as to what the inflation rate will be during the life of the contract. For example, a three-year supply arrangement may provide for an automatic increase in price of ten per cent at the end of the first year and another automatic increase of eight per cent at the end of the second year. The parties then attempt to protect themselves by providing for the renegotiation of the contract in the event economic factors, and in particular inflation, change the situation in such a way that the cost of the product and the price to be paid for it become substantially unbalanced. To do so, the parties often rely on a broadly drafted "hardship clause." The following constitutes an illustration of such a clause :

> "If during the period of this Agreement, any laws, regulations or policies are enacted or enforced by any government or competent authority in Canada, the United States or elsewhere which would create severe hardship to either or both of the parties, or if either party presents information to show that the continued performance of its obligations under this Agreement would likely result in that party incurring a substantial negative economic impact which could not be foreseen at the date of signature of this Agreement, then, notwithstanding anything contained in this Agreement, either party may at its option give written notice to the other party to negotiate to attempt to agree upon a price change under Clause 5 above. Upon the expiration of ninety (90) days after the giving of such notice, this Agreement shall terminate in the event the parties have not agreed upon a price change, subject to the settlement of outstanding accounts."

A hardship clause has the advantage of averting in many instances a disruptive failure of performance by the party who has miscalculated and may facilitate renegotiation by providing a framework within which it may be conducted. However, most often the disadvantages outweigh the advantages. The ever-present possibility of renegotiation renders the contract to some degree unstable, the definition of hardship tends to be vague and imprecise and the purchaser may find himself at a disadvantage because the manufacturer controls the pricing mechanism in many instances.

In the event the parties wish to include a hardship clause, it is advisable to use specific and comprehensive language to deal with the consequences of a failure to agree following renegotiation, the goal being to reduce the uncertainty as to the obligations of the parties at a time of difficulty in their relationship.

Generally, the coupling of "guesstimates" and "hardship clauses" is far from desirable especially when experience shows that the chances of correctly predicting the inflation rate at any given time is not especially good.

Stabilization Clauses

Another way to attempt to preserve the real economic value of a contract is to include what some authors call "stabilization clauses." Clauses of this nature have been used for centuries in trade and commerce. They cover a broad range, from simple commodity clauses to complex mathematical formulae.

Gold and silver clauses and foreign currency clauses are beyond the purview of this discussion. Gold clauses required that the payment be made in specified gold coins, in bullion or by way of a sum of money equal to the value of a specified quantity of gold. Since demonetarization, clauses of this nature have become something of an anachronism in general trade and commerce. Foreign currency clauses require payment in a "hard" currency that may serve as the unit of account or the unit of payment. Clauses of this kind are a convenient technique for shifting exchange risks in international transactions, but they are far from ideal as devices for protecting against inflation because in reality they offer no protection against inflation in the "hard" currency country.

Commodity Clauses

Commodity clauses use commodities as both a measure of value and a means of payment. An easy illustration comes from the rental of farmland on a sharecropping basis. Since the ultimate value of the lease or rental in monetary terms varies with the yield and the market price for the commodities produced, both parties, in theory, share the risk inherent in the transaction.

Commodity-index clauses utilize the price of a commodity or group of commodities only as a measure of value. The means of payment remains currency. Commodities such as wheat, corn, rye and barley have long been used in attempts to stabilize the value of monetary obligations. Nonetheless, clauses of this nature are generally only crude devices to maintain value. The price of a given commodity is frequently subject to volatile fluctuations which may have nothing to do with inflation or the purchasing power of money. When using this type of clause, it is generally more effective to seek a basket of commodities as the reference point.

Index Clauses

The most effective way for most contracting parties to protect themselves against inflation is to link the value of their transaction to a broadly based price index. Because such indexes vary more or less with the purchasing power of money, an index clause can be better tailored to protecting from the consequences of inflation in contemporary markets. Since the development of sophisticated price indexes, index clauses have become enormously popular. Index clauses come under many guises and names : "escalator clauses," "sliding-scale clauses," "monetary correction clauses" or "cost-of-living clauses."

Unless prohibited by specific legislation, index clauses are generally considered valid and enforceable.

There is no "one type" or "ideal" index clause. Clauses vary substantially depending mainly on the intention and sophistication of the contracting parties. When drafting this type of clause, it is good to bear in mind (i) that the escalation formula should reflect the area where the costs are going to be incurred ; (ii) that if the product incorporates materials or components which are supplied by a third party or from another country and are subject to a price escalation

formula, such formula must be built into the pricing clause with the ultimate purchasers, and (iii) that if delay in performance is excused under the contract, price escalation should nonetheless continue at least to the extent that additional costs are in fact incurred.

In addition, substantial care should be taken with respect to the following issues :

(i) The clause should be kept as simple as possible under the circumstances.

This is a cardinal rule of good draftsmanship which takes on special importance with respect to index clauses. Such clauses tend to be inherently complex and great care must be taken when the parties are relatively unsophisticated. There are too many index clauses devised by accountants with the help of economists and translated by lawyers which no one can understand.

(ii) The index chosen should be appropriate to the needs of the contracting parties.

The inflation risks which the parties wish to shift or hedge by indexing will dictate the index to be chosen. For example, if labour costs are of special concern, it may be appropriate to refer to the minimum wage or the consumer price index. Frequently the parties will index the price of a deferred performance contract to a specialized index or a component of a general price index that closely reflects price changes in the subject matter of the contract. Construction contracts are commonly tied to an index of construction costs or a contract to deliver metal cable may be tied to the metal components of the wholesale price index. Moreover, the most appropriate index in some contracts may be a compromise between the conflicting interests of the parties.

(iii) The index should be described with care and specificity.

If a contract is to be indexed to the consumer price index, the clause should specify whether the parties intend to use the national version or that for a particular region or city ; the seasonally adjusted version or the unadjusted version ; and so on.

For example, in *Re Collins Cartage & Storage Co. Ltd. et al. and McDonald* (1980) 103 D.L.R. (3rd) p. 534, Lerner, J. of the Ontario High Court of Justice had to consider a lease in which the rent

was to be "adjusted on the 31st day of July, 1978, and on the 31st day of July, 1983, so that the effective rental at the relevant dates shall not be less than the greater of (a) the current rental ; or (b) the current rental multiplied by a figure which is made up of the then cost of living as a numerator and the cost of living index at July 31st, 1978, as the denominator." The judge came to the conclusion that the clause in question was unenforceable, because he did "not agree that "cost of living" or "cost of living index" in para. 24 of the lease refers, without doubt, to Consumer Price Index of Statistics Canada. It was open to the parties to indicate the source of cost of living and cost of living index as used in the lease with precision to make para. 24 capable, with certainty, of assisting in determining the rent from time to time."

The following provisions serve to illustrate some of the indices used for the calculation of a price change in the cost components of certain steel products :

Iron Ore & Pellets. Lower Lake pellet prices as reported as of the date of publication in *Skillings Mining Review,* published weekly in Duluth, Minnesota by David N. Skillings, Jr. Quoted in United States cents per Fe unit.

Metallurgical Coal. Contract price index for coal metallurgical H.V. Code No. 0512-0303.01 as reported in "Producer Prices and Price Indexes" published monthly by the Bureau of Labour Statistics, United States Department of Labour, Washington, D.C.

Labour. Average weekly earnings (all employees) Canada Iron and Steel Mills SIC 291, as reported monthly by Statistics Canada in *Catalogue 72-002,* "Employment Earnings and Hours" (#D703076). Quoted in Canadian dollars.

Reagents, Manganese. The price as reported as of the referenced week ending date in *Metals Week* magazine, published weekly by McGraw-Hill Publications, New York, New York under the heading "Ferroalloys, Manganese U.S. Metal/Regular." Quoted in United States cents per pound.

Other Costs. The Manufacturing, Total non-food industries, including alcoholic beverages, D634401, as reported monthly by Statistics Canada in *Catalogue 62-011,* "Industry Selling Price Indexes." Index base is 1971 = 100.

The clause should also spell out what happens in the event of a change in the index, such as a switch to a new base year, new market basket survey, or a cessation of publication. Prudence suggests providing for these contingencies by stipulation of a substitute index or conversion formula, by designating an impartial third party to choose a new index or by renegotiating the contract.

(iv) The mechanism whereby the adjustment occurs should be clear and specific.

When is the adjustment to be made : annually, quarterly, monthly or when the index rises by a given percentage or number of points over a given period of time on a cumulative basis ? When does the obligation to increase occur and is it retroactive ? Is there an obligation to decrease if the index falls and if so, at what point ? Is there to be a floor and a ceiling to any escalation ? Will a third party be responsible for monitoring and calculating ?

The following clause will serve to illustrate some of the issues that have to be addressed :

"The price to be paid by Purchaser to Seller for gas delivered shall be the result obtained by multiplying the factor (the "Factor") by the price of gas at the Alberta Border (the "AB") as determined by the Alberta Petroleum Marketing Commission in effect for the month of delivery. The Factor for gas purchased prior to July 1, 1992 shall be one (1.00).

"At least six (6) months prior to July 1, 1992, and at least six (6) months prior to every third July 1 date thereafter during the term of this Contract (each such July 1 date being a "Factor Redetermination Date" and each three-year period from July 1, 1992 being a "Period"), the Purchaser and the Seller shall redetermine the Factor for the next Period, provided that :

(a) The Factor shall not exceed one decimal seventy (1.70) for the Period between July 1, 1992 and July 1, 1995 ;

(b) Beyond July 1, 1995, the Factor for any Period may not increase or decrease by more than zero decimal twenty (0.20) from what it was in the immediate preceding Period ; and

(c) The Factor shall never exceed one decimal ninety (1.90) nor be less than zero decimal fifty (0.50).

"If the Purchaser and the Seller are unable to redetermine a Factor before the Factor Redetermination Date, the Factor shall be

determined by Arbitration as set out in Article YYY of this Contract limited by the terms set out in the next sentence. The arbitrators shall include in their criteria the intent of the Factor which is to derive a price for gas that is similar to those gas prices in effect at the time of arbitration for gas delivered to Alberta high-load factor industrial gas consumers for reliable, long-term gas supplies, purchased under similar terms and conditions as contained in this Contract, from viable, quality gas suppliers."

566 Generally, the best advice with respect to protecting a contract from the distortions brought about by inflation is most often to encourage the parties to agree on a carefully drafted index clause adapted to the circumstances of the contractual relationship. An index clause will not entirely do away with the effects of inflation if only because price indexes record previous price changes. The corrective effect of indexation alone usually lags behind the actual changes in the purchasing power of money.

However, there is hope.

The United States Congress proposes to make inflation illegal. Representative Stephen L. Neal (D-N.C.), Chairman of the House Domestic Monetary Policy Subcommittee, has introduced a resolution directing the Federal Reserve Board to cut inflation in the United States to zero in five years – and keep it there. Federal Reserve Board Chairman Alan Greenspan is scheduled to testify in favour of the resolution on October 25, 1989. Enthusiasm must be tempered, nonetheless. Previous attempts to legislate economic goals do not add up to encouraging precedents.