

Minding the Gap: Determining Interest Rates Under the U.N. Convention for the International Sale of Goods

Karin L. Kizer†

Whatever may have been our archaic notions about interest, in modern financial communities . . . [t]he present use of my money is itself a thing of value, and, if I get no compensation for its loss, my remedy does not altogether right my wrong.¹

In *Delchi Carrier, SpA v Rotorex Corp.*,² a United States District Court respected this principle and added interest to damages awarded under a contract between a U.S. seller and an Italian buyer. The contract, however, did not specify an interest rate or a governing national law, nor did international law offer a solution. Thus, lacking a clear default rule, the court awarded the interest rate on U.S. Treasury bills.³

This lack of a default rule has important consequences for international trade. Default rules play an important role in contract law, lowering transaction costs because parties need not explicitly negotiate every aspect of a contract. Moreover, these rules give courts a predictable way to complete the contract when the parties, for whatever reason, leave out a term. In U.S. law, Article 2 of the Uniform Commercial Code ("UCC") provides an example of such gap-filling rules.⁴

In international law, the United Nations Convention for the International Sale of Goods ("CISG") serves a gap-filling function comparable to the UCC. For traders whose places of business are located in CISG Member Nations,⁵ the treaty sets out broad, uni-

† B.A. 1988, University of Arizona; M.A. 1990, School of Advanced International Studies, Johns Hopkins University; J.D. Candidate 1999, The University of Chicago.

¹ *Procter & Gamble Distributing Co v Sherman*, 2 F2d 165, 166 (S D NY 1924).

² 1994 US Dist LEXIS 12820, *1 (N D NY) (unpublished opinion).

³ *Id.* at *18.

⁴ UCC § 1-102 states that unless parties contract around its provisions, the UCC will resolve any gaps in a given agreement. Some provisions, however, such as the duty of good faith, are immutable and always apply to a contract. UCC § 1-102(3), reprinted in *Uniform Laws Annotated*, Master Edition 1, 12 (West 1989).

⁵ *United Nations Conference on Contracts for the International Sale of Goods*, UN Doc A/CONF.97/18, Art 1(a) ("CISG"), reprinted in 19 ILM 671 (1980). The CISG took effect January 1, 1988. It automatically applies to contracts between traders who are citizens of a Member Country. As of December 1997, the Member Countries were Argentina, Austra-

form rules to govern the burgeoning international trade in goods, valued at more than \$5 trillion in 1996.⁶ This uniformity makes transactions more predictable and lessens the complexity of already complex transactions.⁷ However, some CISG provisions represent incomplete compromises rather than a consensus on a particular practice. One such provision is Article 78,⁸ which ensures that when one party fails to pay the other on time, the injured party—referred to as the “creditor”—receives interest on the amount he is owed by the delinquent party, or “debtor.”⁹ Although the CISG’s negotiators did agree that interest should be awarded on delinquent payments, they could not agree, given

lia, Austria, Belarus, Belgium, Bosnia & Herzegovina, Bulgaria, Canada, Chile, China, Cuba, Czech Republic, Denmark, Ecuador, Egypt, Estonia, Finland, France, Georgia, Germany, Greece, Guinea, Hungary, Iraq, Italy, Latvia, Lesotho, Lithuania, Luxembourg, Mexico, Moldova, Mongolia, Netherlands, New Zealand, Norway, Poland, Romania, Russian Federation, Singapore, Slovakia, Slovenia, Spain, Sweden, Switzerland, Syrian Arab Republic, Uganda, Ukraine, United States, Uzbekistan, Yugoslavia, and Zambia. The CISG can also govern contracts when the rules of private international law—international conflicts of laws rules—require the law of a contracting state to apply. CISG, Art 1(b).

⁶ *Delivering the Goods*, Economist 85 (Nov 15-21, 1997) (discussing increase in yearly international trade over 1986-96 decade from \$2 trillion to \$5.2 trillion).

⁷ One commentator describes the complexity a U.S. company may encounter when it enters international markets: “[The company’s entry] may be traumatic. Intense preparation may lead to few sales. The company may be exposed not only to substantial marketing risks but to legal, tax, and fiscal risks when company activities are formulated around an insufficient understanding of local laws and regulations. One ‘minor’ law may undo years of goodwill and profits.” Stephen J. McGarry, *Pathfinder For Doing Business Abroad*, 22 Intl Law 483, 483 (1988) (citations omitted).

⁸ Article 78 reads: “If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under Article 74.” CISG, Art 78 (cited in note 5). Article 84(1) includes a similar commitment to pay interest when the seller must refund the buyer’s payment; however, it is subsumed under Article 78’s general obligation to pay interest. See John O. Honnold, *Uniform Law for International Sales* § 451.2 at 572-73 (Kluwer 2d ed 1991). For the purposes of this Comment, Article 84(1) will not be considered separately.

Article 78 is also silent on when interest accrues, another issue not explored in this Comment. Most decisions are in accord that interest accrues from the time the payment is due. See, for example, *Parties Unknown*, Arbitral Award SCH-4366 (Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft 1994) (Wien), reprinted in Michael Joachim Bonell, ed, *International Case Law and Bibliography on the UN Convention on Contracts for the International Sale of Goods (“UNILEX”)* E1994-14 at 333 (Transnational Juris 1997). Complexities arise when the buyer, rather than the seller, is due interest. See, for example, *Parties Unknown*, ICC Award No 8128/1995 (Intl Ct Arb 1995) (Paris), reprinted in *UNILEX* E1995-34 at 542.3-4 (awarding interest on seller’s reimbursement to buyer from date buyer avoided contract because seller failed to deliver, and on other damages from date buyer resorted to substitute performance).

⁹ Under the UCC, it is unclear whether Article 2 provides similar protection because interest has traditionally been considered a part of consequential damages. Thus, while buyers are assured interest—so long as it was foreseeable—under UCC § 2-715, some courts have held that sellers may not recover interest under UCC § 2-710. See Henry Gabriel, *Practitioner’s Guide to the Convention on Contracts for the International Sale of Goods (CISG) and the Uniform Commercial Code (UCC)* 237-38 (Oceana 1994).

global economic conditions, on what particular interest rate should apply.¹⁰

This compromise—ensuring the right to interest without providing a rate formula—leaves a gap in the CISG structure that creates uncertainty about how to compensate a creditor when parties fail to pick either a rate¹¹ or a national law to cover gaps in the contract.¹² In such a case, adjudicators must choose a rate to apply, which can be administratively costly and which, given the range of possible choices, is likely to result in selection of an inappropriate rate.

A hypothetical transaction illustrates this problem.¹³ Suppose a German buyer contracts with an Egyptian seller for Egyptian cloth to produce shirts in Hungary. They select the CISG as governing law because both their countries are CISG signatories. Both agree that the cloth should be delivered in Hungary to minimize shipping costs. All goes as planned until the German buyer, claiming the seller has substituted an inferior product, refuses to pay for the cloth. Short on funds to pay his bills, the Egyptian seller borrows eurodollars to cover himself, but still expects to be paid. Unable to resolve the dispute, the parties agree to arbitrate.¹⁴ The arbitrator rules for the Egyptian seller, requiring the German buyer to pay for the goods. Applying the CISG's Article 78, the arbitrator awards the seller interest on the payment owed to him.

The question is now: "What rate should apply?" The CISG, which the parties specified as the governing law, provides no an-

¹⁰ These conditions included high market-based rates in industrial countries suffering from inflation, low rate ceilings set by statute in planned economies, and no rates in Islamic countries where, for religious reasons, interest is banned. See text accompanying notes 30-43.

¹¹ Obviously, when parties select a rate, the adjudicator's task is simple. Similarly, if parties explicitly exclude the CISG from their contract, as they are permitted to do under the treaty's Article 6, adjudicators must apply other law to determine whether the debtor owes the creditor interest and, if so, at what rate.

¹² One practitioner's guide to the CISG suggests a sample clause governing the determination of interest to include in international contracts. See Peter Winship, *Changing Contract Practices in the Light of the United Nations Sales Convention: A Guide for Practitioners*, 29 Intl Law 525, 552-53 (1995) (recommending a clause providing that interest begins to accrue at default and directing the parties to select an interest rate).

¹³ For a general discussion of private international commercial transactions, see John H. Jackson, William J. Davey, and Alan O. Sykes, Jr., *International Economic Relations* ch 2 (West 3d ed 1995).

¹⁴ Increasingly, arbitral organizations, such as the International Court of Arbitration of the International Chamber of Commerce ("ICC"), are publishing their awards. These decisions provide a key source for interpreting the Convention. Additionally, many reported decisions applying the CISG are national court decisions (primarily Western European); these decisions are only persuasive as a source of international law. See *UNILEX* C3-78 at 159-62.1 (cited in note 8) (listing reported decisions interpreting CISG, Art 78).

swer to this question. Indeed, although the CISG recommends that adjudicators interpret incomplete provisions such as Article 78 in a way that promotes uniformity,¹⁵ no uniform solution has appeared. In many cases where adjudicators face situations like this hypothetical transaction, they apply conflict of laws rules to identify a national law to fill the gap and award a rate under that country's laws.¹⁶ Such was the route chosen in the one U.S. case to consider this issue.¹⁷ In other cases, adjudicators have awarded interest rates commonly used in international trade.¹⁸ A third route is to identify rates that fully compensate the creditor for any injury caused by the late payment—in the example above, the rate at which the Egyptian seller borrowed eurodollars.¹⁹

This Comment proposes a solution to this problem by combining treaty interpretation and economic analysis to identify a sensible default rule. Part I reviews the role of default rules in contract theory and the methods adjudicators use to decide what interest rate to apply under the CISG. Part II evaluates—in terms of their success as default rules—the various solutions that adjudicators have developed. Part III then proposes a two-part solution that combines elements of the current approaches to ensure that injured parties receive the benefit of the bargain: awarding a savings rate for the payment's currency unless the creditor must borrow due to the late payment. In the latter case, courts should award his borrowing rate.

I. IDENTIFYING DEFAULT RULES UNDER ARTICLE 78

A. A Framework for Analyzing the Gap

Contracts often fail to specify terms that may later become crucial for the adjudication of disputes; when such disputes arise, adjudicators must fill in the gaps. To do so, they often employ background or default rules that complete the contract either with terms that the parties would have negotiated had they addressed the issue (a market-mimicking default rule) or with terms that force the parties to contract around the rule (a penalty default rule).²⁰

¹⁵ CISG, Art 7(1) (cited in note 5).

¹⁶ See Part II.B.

¹⁷ See *Delchi Carrier*, 1994 US Dist LEXIS 12820 at *10-11.

¹⁸ See, for example, *Aguila refractarios SA s/Conc preventivo* (Juzgado Nacional de Primera Instancia en lo Comercial No 10 1991) (Argentina), reprinted in *UNILEX E1991-10.1* at 80.1 (cited in note 8) (awarding prime rate as trade usage).

¹⁹ See Part II.E.

²⁰ See Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L J 87, 92-93 (1989) (arguing that "penalty" de-

Market-mimicking default rules maximize the bargain's efficiency by lowering transaction costs. Such rules allow the parties to avoid haggling over every part of the contract, reduce the time and expertise required to negotiate a contract, and lessen the risk that the contract will fall through because the parties distrust each other.²¹ Penalty default rules fill gaps with provisions that the parties would not have selected. By doing so, the rules force a contracting party to reveal information in the negotiations that he might otherwise withhold in order to avoid the penalty outcome. When it is easier for parties to a contract to select the outcome they would prefer than for a court to do so after a dispute arises, penalty defaults can be more efficient than market-mimicking rules.²²

Considerations of how costly it is to choose and apply a solution (decision costs) and the possible costs of inaccurate solutions (error costs) impact the choice of a default rule. For example, one rule may be easier for adjudicators to apply because it is simple or the information it requires is readily available, but it may not in fact resolve the problem correctly. Such a rule would have low decision costs but high error costs. Ultimately, a default rule should minimize the sum of these two costs.

B. Identifying Default Rules in the CISG: General Principles, National Laws, and Trade Usages

Rather than explore the transaction costs, decision costs, and error costs of a particular rule, commentators and adjudicators have typically framed issues under the CISG exclusively in terms of treaty interpretation.²³ By using different approaches to interpret the CISG, adjudicators have failed to develop a uniform rule that adequately protects the creditor's interests.²⁴ Part II will ex-

faults are more efficient and appropriate).

²¹ See Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 Colum L Rev 1710, 1755-56 (1997) (arguing that default rules that deviate from trade usages may require negotiation and thus may involve prohibitive transaction costs).

²² See Ayres and Gertner, 99 Yale L J at 94-95 (cited in note 20).

²³ These commentators are out of step with those in other areas of international law, where scholars are applying economic analysis. See, for example, Ugo Mattei, *Comparative Law and Economics* 179-99 (Michigan 1997) (applying economic analysis of law to civil and common law treatment of penalty clauses in contracts); Thomas W. Waelde and George Ndi, *Stabilizing International Investment Commitments: International Law Versus Contract Interpretation*, 31 Tex Intl L J 215, 266 (1996) (using economic analysis of law to develop standards for resolving international investment contract disputes); William J. Aceves, *The Economic Analysis of International Law: Transaction Cost Economics and the Concept of State Practice*, 17 U Pa J Intl Econ L 995, 1002 (1996) (arguing that transaction costs influence treaty negotiations in a similar way to private contracts).

²⁴ Compare Franco Ferrari, *Uniform Application and Interest Rates Under the 1980*

plore how that objective can best be achieved. First, however, this Comment examines the textual support for the three primary default rules that adjudicators have adopted: relying on general principles, looking to national law, and considering trade usages.

Article 7 of the CISG provides:

(1) In the interpretation of this Convention, regard is to be had to its *international character* and to the need to promote *uniformity* in its application and the observance of good faith in international trade.

(2) Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the *general principles* on which it is based or, in the absence of such principles, in conformity with the *law applicable by virtue of the rules of private international law*.²⁵

Thus, while the CISG encourages uniform international solutions, the text itself provides two different approaches to resolving unsettled questions.²⁶ First, when the CISG addresses but does not “expressly settle” a particular issue, one can reason from the CISG’s general principles. Second, if none of the CISG’s general principles are applicable, an adjudicator can use appropriate rules of private international law to determine what law should fill the gap.²⁷ Although this framework appears straightforward, commentators and adjudicators disagree over how it applies to selecting an interest rate under the CISG. Some argue that, because the rate question is “governed” but not “expressly settled”

Vienna Sales Convention, 24 Ga J Intl & Comp L 467, 477-78 (1995) (arguing for application of domestic law to determine interest rate), with Phanesh Koneru, *The International Interpretation of the UN Convention on Contracts for the International Sale of Goods: An Approach Based on General Principles*, 6 Minn J Global Trade 105, 123-34 (arguing that general principles should be used to fill interest gap); Alejandro M. Garro, *The Gap-Filling Role of the UNIDROIT Principles in International Sales Law: Some Comments on the Interplay Between the Principles and the CISG*, 69 Tulane L Rev 1149, 1186-89 (1995) (advocating using International Institute for the Unification of Private Law (“UNIDROIT”) Principles to fill Article 78 gap); and Honnold, *Uniform Law for International Sales* § 421 at 525-26 (cited in note 8) (advocating use of CISG’s general principles to determine rate).

²⁵ CISG, Art 7 (cited in note 5) (emphasis added).

²⁶ Gaps governed by treaty principles are often referred to as *lacuna praeter legum*; gaps relating to issues explicitly excluded from coverage are *lacuna intra legum*. See Franco Ferrari, *Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing*, 15 J L & Commerce 1, 120-21 (1995) (analyzing Article 78 interest rate gap).

²⁷ Ranking general principles first and private international law second was a compromise between those parties who wanted a more code-like solution and those who thought discerning general principles would be difficult. See Honnold, *Uniform Law for International Sales* § 96 at 148-50 (cited in note 8).

by the treaty, it should be decided using general principles.²⁸ Others find that no general principles apply to this provision and thus national laws should govern.²⁹

Much of this confusion stems from the CISG's negotiating history.³⁰ The treaty's predecessor, the Uniform Law for the International Sale of Goods ("ULIS"), guaranteed a creditor interest on any delayed payments and specified a formula to determine that rate.³¹ During the talks leading to the CISG in the late 1970s, the negotiators tried to amend this formula to make it more flexible.³² However, competing economic ideologies and political systems made it difficult to reach a common solution. Many negotiators supported a new formula that focused on compensating the creditor.³³ However, some negotiators feared that using rates in the creditor's country would encourage a debtor to delay when those rates were *lower* than in the debtor's country, unjustly enriching the debtor who delayed payment to take advantage of favorable rates. Instead, they advocated using analogous rates in the debtor's country.³⁴ This proposal, however, was criticized for possibly undercompensating the creditor, if he were forced to borrow at higher rates than those prevailing in the debtor's country while awaiting payment.³⁵ Furthermore, com-

²⁸ See notes 77-78 and accompanying text.

²⁹ See text accompanying notes 60-65.

³⁰ A treaty's negotiating history is often used by courts and arbitrators in the same way as the legislative history of a domestic law.

³¹ See *Report of the Secretary-General: Pending Questions With Respect to the Revised Text of a Uniform Law on the International Sale of Goods*, DOC A(10)(b) (A/CN.9/100), Annex III, 88, 107 (1975), reprinted in John O. Honnold, *Documentary History of the Uniform Law for International Sales: The Studies, Deliberations and Decisions that Led to the 1980 United Nations Convention with Introductions and Explanations* 232 (Kluwer 1989). Article 83 of ULIS read:

Where the breach of contract consists of delay in the payment of the price, the seller shall in any event be entitled to interest on such sum as in arrear at a rate equal to the official discount rate in the country where he has his place of business or, if he has no place of business, his habitual residence, plus 1 per cent.

Progress Report of the Working Group on the International Sale of Goods on the Work of Its Fifth Session, DOC A(9) (A/CN.9/87), 29, 59 (1974), reprinted in Honnold, *Documentary History* at 190.

³² *Report of the Working Group on the International Sale of Goods on the Work of Its Sixth Session*, DOC A(11) (A/CN.9/100), 49, 62 (1975), reprinted in Honnold, *Documentary History* at 253 (cited in note 31).

³³ See, for example, *First Committee Deliberations, 29th Meeting, Statement by Mr. Farnsworth (United States of America)*, DOC C(4) (A/CONF.97/C.1/SR.29), OR 236, 391 (1980), reprinted in Honnold, *Documentary History* at 612 (cited in note 31).

³⁴ *UNCITRAL: Preparation of the 1977 UNCITRAL "Sales" Draft*, DOC B(1) (A/32/17), Annex I, Art 58, ¶ 493 at 60 (1977), reprinted in Honnold, *Documentary History* at 353 (cited in note 31).

³⁵ *Id.* ¶ 494 at 60.

munist countries were worried that a creditor's rate—especially the highly inflationary rates in industrial countries—would violate their statutory interest rate ceilings,³⁶ Islamic countries that banned interest also opposed the proposal.³⁷ In addition, developing countries wanted a rate used in international markets because they had no domestic financial markets.³⁸ Still others rejected any need for an interest rate formula because any actual borrowing costs could be recovered under a general claim for damages.³⁹ Unable to accommodate all these views,⁴⁰ the parties instead reached a compromise solution—now Article 78—guaranteeing a right to interest but remaining silent on the particular rate.

These divergent views have led some adjudicators and commentators to conclude that because no single principle can accommodate all these concerns, interest rate questions should be settled by national laws.⁴¹ Others reason that times have changed, pointing to market reforms in former communist countries, low inflation throughout the global economy, and integrated capital markets—all of which make financing international commercial transactions simpler and more common. Moreover, although some Islamic countries officially continue to ban interest, their laws permit charging some compensation on arrears in commercial transactions.⁴² Given these conditions, the argument

³⁶ *First Committee Deliberations, 34th Meeting, Statement of Mr. Wagner (German Democratic Republic)*, DOC C(4) (A/CONF.97/C.1/SR.34), OR 415, 416 (1980), reprinted in Honnold, *Documentary History* at 637 (cited in note 31).

³⁷ *First Committee Deliberations, 34th Meeting, Statement of Mr. Shafik (Egypt)*, DOC C(4) (A/CONF.97/C.1/SR.34), OR 415, 416 (1980), reprinted in Honnold, *Documentary History* at 637 (cited in note 31).

³⁸ *First Committee Deliberations, 34th Meeting, Statement of Mrs. Vilus (Yugoslavia)*, (A/CONF.97/C.1/SR.34), OR 415, 416-17 (1980), reprinted in Honnold, *Documentary History* at 637 (cited in note 31). See generally *Decision in the Plenary Conference, 10th Plenary Meeting*, DOC C(7) (A/CONF.97/SR.6), OR 199, 223-25 (1980), reprinted in Honnold, *Documentary History* at 758-60 (discussing Article 78, referred to as Article 73 in text).

³⁹ *UNCITRAL: Preparation of 1977 UNCITRAL "Sales" Draft*, Annex I, Art 58, ¶ 497 at 60 (cited in note 34).

⁴⁰ *Id.* ¶ 499 at 60.

⁴¹ See generally Ferrari, 15 *J L & Commerce* 1 (cited in note 26) (reviewing application of CISG generally); Eva Diederichsen, *Commentary to Journal of Law & Commerce Case I; Oberlandesgericht, Frankfurt am Main*, 14 *J L & Commerce* 177, 180-81 (1995) (discussing German cases interpreting the CISG in light of diverse legal views of negotiators).

⁴² For example, Egyptian law requires that interest be paid on late payments. See John Y. Gotanda, *Awarding Interest in International Arbitration*, 90 *Am J Intl L* 40, 47 (1996) (analyzing interest rate in international commercial arbitration generally). See also Daniel Klein, Comment, *The Islamic and Jewish Laws of Usury: A Bridge to Commercial Growth and Peace in the Middle East*, 23 *Denv J Intl L & Pol* 535, 536-38 (1995) (discussing differing views of Islamic law's ban on interest). Moreover, traders in some countries simply choose another country's laws to govern the contract, avoiding any restrictions entirely. See *Parties Unknown*, ICC Award No 6653/1993 (Intl Ct Arb 1993) (Paris), re-

goes, using national laws out of respect for the negotiators' outdated concerns makes little sense, and the CISG's general principles provide a better solution.⁴³

The text of the CISG's Article 9, which governs trade usages, supports a third default rule. Article 9(2) reads:

The parties are considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.⁴⁴

Relying on this Article, an adjudicator can fill the gap in a contested contract with an applicable trade practice. Trade usages have traditionally played an important role in developing international trade and are increasingly accepted as a source of international commercial law.⁴⁵ While adjudicators have looked to such customs in awarding interest under the CISG,⁴⁶ they have done so infrequently. Nevertheless, because the treaty incorporated trade usages, these practices should be explored as a possible source for an international solution.

II. ANALYSIS OF THE CURRENT SOLUTIONS

The previous Part identified the default rules the CISG provides for filling its interest rate gap. This Part will analyze the outcomes produced by those rules. Before looking at those outcomes, however, it is useful to understand the contract principles served by an interest award, the economics underlying the choice of a specific interest rate, and the various rates that could be used to compensate for delayed payments.

printed in *UNILEX* E1993-1 at 208 (cited in note 8) (using parties' selection of French law to apply CISG to contract), rev'd in part on other grounds, *Thyssen Stahlunion GmbH v Maaden General Foreign Trade Organisation Bulding Materials* (CA Paris, 1ère ch 1995) (France), reprinted in *UNILEX* E1995-12.1 at 456.3.

⁴³ See, for example, Koneru, 6 *Minn J Global Trade* at 105 (cited in note 24) (reasoning that the CISG should be interpreted using general international legal principles).

⁴⁴ CISG, Art 9 (cited in note 5).

⁴⁵ See Mark Garavaglia, *In Search of the Proper Law in Transnational Commercial Disputes*, 12 *NY L Sch J Intl & Comp L* 29, 29-32 (1991) (reviewing history of international commercial arbitration and arguing for increased application of business customs in international commercial transaction cases).

⁴⁶ See Part II.D.

A. The Economics of Interest Rates

One function of interest rates is to preserve the time value of money for the injured party. All else being equal, money today is worth more than money tomorrow because it can be invested today for some positive return. Consequently, the deferred receipt of funds should be compensated by some interest on those funds.⁴⁷ Two other factors affect money's value in international trade: inflation and depreciation, or a currency's decline in value relative to other currencies. Nominal rates protect against the former by providing an inflation premium.⁴⁸ Using nominal rates that apply to a particular currency protects against any loss in that currency's value from depreciation.⁴⁹

Basic contract principles suggest two purposes for awarding interest—compensation and restitution. Rates that reflect the creditor's cost of capital are compensatory; they ensure that the injured creditor's delayed payment maintains the same value it would have but for the debtor's breach, ensuring the injured party the benefit of the bargain. Conversely, rates that reflect a debtor's cost of borrowing are restitutionary; they aim to prevent the debtor from unjustly enriching herself at the creditor's expense by taking what amounts to an interest-free loan from the creditor.⁵⁰ Depending on whether a compensatory or restitutionary approach is chosen, appropriate rates come from a variety of sources.

A compensatory approach, favored by creditors, would analyze the overall cost of the firm's capital to assess what rate of return it must earn to be profitable. This rate of return reflects the firm's opportunity cost of its funds. Firms have two basic sources of funds: debt and equity. The weighted average of its payments for these funds (the "weighted average cost of capital")⁵¹ could be

⁴⁷ See Eli Schwartz, *Theory and Application of the Interest Rate* 2 (Praeger 1993) (discussing general theory of interest rates).

⁴⁸ The nominal rate of interest is that rate at which one can borrow funds on the market. It includes a premium for future inflation and thus differs from the real interest rate by the expected future change in the price level. Expressed algebraically, the real interest rate (r) is a function of the nominal interest rate (i) adjusted for inflation (p), or $(1 + i)/(1 + p) - 1 = r$. *Id.* at 11.

⁴⁹ *Id.* at 53-54.

⁵⁰ See Charles L. Knapp and Nathan M. Crystal, *Problems in Contract Law: Cases and Materials* 892-93 (Little, Brown 3d ed 1993) (discussing general principles of contract damages). These basic interests are represented in both common and civil law systems. See Stephen Cromie, *International Commercial Litigation* 249-51, 254-57, 263 (Butterworths 2d ed 1997) (discussing English, French, German, and Swiss systems).

⁵¹ This basic definition is from the theorem popularized by Merton Miller and Franco Modigliani, which yields the conclusion that if investment strategy is held constant there is no optimal mix of debt and equity; the cost to the firm is constant because it is based on

applied as the appropriate rate to compensate the creditor for the deferred payment.

Computing the weighted average cost of capital is not necessary where the firm has not relied on its cash balances,⁵² but instead has borrowed money to finance the late payment. Delayed payments frequently cause a shortfall in cash flow, leaving a firm unable to meet its other financial obligations. Firms have a number of sources of short-term capital with which to cover such shortfalls.⁵³ The interest rate awarded should be the cost of the source from which the creditor borrowed to cover the shortfall. The firm may already have a line of credit—an agreement that permits it to withdraw up to a set amount of funds from a financial institution—that it can use for a prearranged rate. Or it might take out a short-term loan from its bank to cover the amount of the payment, negotiating with the bank for a specific rate. Or it may have marketable securities such as central bank notes or negotiable certificates of deposit that it can sell to cover the shortfall.⁵⁴ Here, although the firm pays no interest, an appropriate rate will compensate it for the interest it would have earned on the cashed-in securities. A firm might also borrow on international markets, such as the eurocurrency markets, comprised of deposits of currencies outside the political jurisdiction where they are issued.⁵⁵ The rate applied to these loans is the London Interbank Offered Rate (“LIBOR”), adjusted by a percentage based on a borrower’s risk.⁵⁶ Although generally used by large multinational firms, firms in countries with undeveloped capital markets (for example, developing countries or former communist countries) also rely on this market for borrowing.⁵⁷

how risky a venture the firm is overall. See Schwartz, *Interest Rate* at 29-31 (cited in note 47).

⁵² Firms keep uninvested cash on hand both to cover pending transactions and as a precaution for unexpected outlays. *Id.* at 401 (discussing how firms optimize ratio of cash on hand to invested funds). Having a shortage of cash can require a firm to take funds out of marketable securities, thus losing some investment income.

⁵³ For a discussion of hedging and the different risks of long- and short-term financing, see James C. Van Horne, *Financial Management and Policy* 481-87 (Prentice Hall 5th ed 1980).

⁵⁴ For a discussion of the more prominent types of marketable securities, see *id.* at 411-14.

⁵⁵ See John Williamson, *The Open Economy and the World Economy: A Textbook in International Economics* 316 (Basic Books 1983) (discussing the eurocurrency markets).

⁵⁶ This risk is a function of the default risk of the borrower himself (for example, how likely he is to go bankrupt) as well as country risk—the likelihood that borrowers from a particular country will be unable to repay a loan because of government actions in that country. See *id.* at 317-18.

⁵⁷ See *id.* at 318.

Awarding interest at these rates looks at the problem from the creditor's perspective. One could, however, view the problem from the debtor's perspective and award a rate that reflects his borrowing costs to address restitutionary concerns. This approach, the coerced loan theory, treats the late payment as a loan from the creditor to the debtor because the debtor, by not paying, can use these funds interest-free.⁵⁸ It is less clear what rate should be used to approximate the rate at which the creditor "lends" to the debtor. Commentators who advocate this theory in other contexts support using a commercial rate for unsecured short-term loans.⁵⁹

A final possible approach is to award a rate associated with government-issued debt (for example, the U.S. Treasury bill rate) or prime rate (that is, the rate paid by the most creditworthy borrowers) for the currency in which the payment is made. Although unadjusted for either party's risk, these rates still preserve the time value of money by recognizing that delaying payments imposes costs on the creditor.

The legal rules discussed in Part I—applying national laws, using the CISG's general principles, and incorporating trade usages—lead to varying selections from among these different rates. How well these rates, and the rules that use them, satisfy the CISG's objective of uniform, international application is discussed below. Additionally, these default rules are analyzed in terms of how well they lower transaction, decision, and error costs.

B. Using National Laws: Statutory Rates

Many adjudicators, especially national courts,⁶⁰ reason that because the negotiators did not specify a rate or formula, they meant for the interest rate question to be resolved by national laws.⁶¹ One commentator argues that so long as adjudicators use

⁵⁸ This concept is a common one in bankruptcy theory; it is also used as the analytical framework for examining awards of prejudgment interest. See, for example, Michael S. Knoll, *A Primer on Prejudgment Interest*, 75 *Tex L Rev* 293, 297, 308-11 (1996) (advocating application of a rate for prejudgment interest that reflects what the defendant should pay for unsecured debt).

⁵⁹ See *id.* at 312-13.

⁶⁰ One commentator suggests that, because legal training is rooted in national systems, national solutions come more readily. See Hans Smit, *Substance and Procedure in International Arbitration: The Development of a New Legal Order*, 65 *Tulane L Rev* 1309, 1311-12 (1991) (arguing for the use of international rather than national rules for international commercial transactions).

⁶¹ Some commentators also stress the compromise nature of the CISG as a reason to rely on national laws. See, for example, Diederichsen, 14 *J L & Commerce* at 177 (cited in

the same type of law—often the creditor's—this kind of procedural consistency sufficiently fulfills the CISG's pledge to promote uniformity.⁶² Others note that because the CISG embodies indeterminate general principles, identifying one and determining how it applies concretely to a given case may be difficult, leaving recourse to national laws as the best solution.⁶³ Such an approach finds support in the CISG's preamble, which states that in promoting uniformity in international trade, one should "take into account the different social, economic and legal systems" of the parties.⁶⁴ In addition, disputes over interest rate awards not governed by the CISG are resolved with reference to national laws.⁶⁵

This solution, however, is neither uniform nor international, two of the treaty's key objectives. Moreover, this approach creates additional problems in its application. First, it is not always clear from conflict of laws doctrine which nation's law should be applied.⁶⁶ The determination of which law to apply thus entails high decision costs in adjudication and high transaction costs by promoting uncertainty in contract negotiation.⁶⁷ Second, courts will

note 41) (discussing German cases interpreting the CISG with regard to the "widely differing legal systems" represented by the parties to the CISG). Diederichsen mentions the negotiators' inability to select a rate as well as their rejection of an explicit reference to domestic law. *Id.* at 180. However, Diederichsen also reasons that, because the result of German conflict of law rules is to apply the national law most closely associated with the contract, the reasonable expectations of both parties are likely to be met. *Id.* at 181.

⁶² See Ferrari, 24 Ga J Intl & Comp L at 468-71 (cited in note 24); Ferrari, 15 J L & Commerce at 116-25 (cited in note 26) (discussing use of conflicts of laws rules in selecting interest rate under Article 78).

⁶³ See Note, *Unification and Certainty: The United Nations Convention on Contracts for the International Sale of Goods*, 97 Harv L Rev 1984, 1991-92 (1984) (arguing that the compromise of Article 78 provided only a "theoretical hierarchy of authority" without standards for proceeding within that hierarchy). For example, one commentator reasons that the Article 78 gap should be filled by the general principle that the seller's law governs. Maria del Pilar Perales Viscasillas, *UNIDROIT Principles of International Commercial Contracts: Sphere of Application and General Provisions*, 13 Ariz J Intl & Comp L 381, 405 (1996).

⁶⁴ CISG, Preamble (cited in note 5).

⁶⁵ See Gotanda, 90 Am J Intl L at 53 (cited in note 42) (discussing cases where arbitrators have applied various national rates).

⁶⁶ Private international law rules are essentially conflict of laws rules in an international setting. This Comment uses the terms interchangeably. For a general discussion of international conflict of laws rules, see Lea Brilmayer, *Conflict of Laws: Cases and Materials* ch 7 (Little, Brown 4th ed 1995).

⁶⁷ See, for example, *Parties Unknown*, 3 KfH 0 97/89 (LG Stuttgart 1989) (Germany), reprinted in *UNLEX* E1989-5 at 15 (cited in note 8) (recognizing that the CISG does not determine interest rate and awarding interest based on seller's domestic law because seller was affected party and seller's currency was the mode of payment); *Gruppo IMAR SpA v Protech Horst BV*, 920150 (Rb Roermond 1993) (Netherlands), reprinted in *UNLEX* E1993-14 at 239 (cited in note 8) (using Dutch and Italian law to select an appropriate interest rate).

often be required to apply the law of a country other than their own, with which they may not be familiar, further increasing uncertainty and, consequently, transaction and error costs. Finally, national laws differ on whether interest rate calculations are procedural or substantive, resulting in different treatment in different fora, a further source of uncertainty.⁶⁸

The outcomes produced by the national law solution impose a variety of costs as well. First, the solution creates incentive problems when rates are different. If the statutory rates are lower than rates in the debtor's country, the debtor may be encouraged to withhold payment and may resist a claim for settling at the creditor's actual costs.⁶⁹ Second, reliance on national law often leads to the application of statutory rates that may be considerably lower than prevailing commercial rates,⁷⁰ paying no heed to whether a party is compensated or unjustly enriched. Moreover, given economic realities such as the European Monetary Union and the role of the dollar in Latin American and Asian financing,⁷¹ rates that apply to a national currency may not protect against inflation when a creditor borrows in a foreign currency.⁷² In sum, this rule promotes uniformity only in a procedural sense⁷³ and is inefficient as well.

⁶⁸ Procedural law prescribes methods to enforce or redress rights; substantive law defines those rights and duties. When faced with a conflict of laws problem, the law of the place where the case is tried governs procedural law; which substantive law to apply depends on the nature of the underlying dispute. An example illustrates the problem. Consider an arbitration taking place in England in which English law governs procedure but German law governs the substantive provisions. In England, liability for interest is governed by substantive law, but determining the rate is procedural. In contrast, under German law both are substantive. Thus, the arbitrator would use German law to determine the breaching party's liability but would use English law to determine the rate. Had the arbitration occurred in Germany, the arbitrator would have used German law to answer both questions. Gotanda suggests a similar hypothetical. Gotanda, 90 Am J Intl L at 51-53 (cited in note 42). See also David J. Branson and Richard E. Wallace, Jr., *Awarding Interest in International Commercial Arbitration: Establishing a Uniform Approach*, 28 Va J Intl L 919, 931-33 (1988) (arguing that the site where the dispute is adjudicated can further complicate the question).

⁶⁹ However, in some instances, courts have resorted initially to the statutory rate but then awarded the injured party her actual costs of borrowing when she could prove them. See *Survey of Previous Decisions by German Courts Applying the CISG: Selected Passages*, 14 J L & Commerce 225, 227-29 (1994) (reporting in part decisions from several German cases addressing interest rate determination under Article 78).

⁷⁰ See Branson and Wallace, 28 Va J Intl L at 924-27 (cited in note 68) (noting that statutory rates are frequently substantially lower than market rates). As Gotanda observes, in many instances, countries do not regularly update their statutory rate. Gotanda, 90 Am J Intl L at 50 (cited in note 42).

⁷¹ See Diana I. Gregg, *Summers Says Euro Not a Threat to Dollar as World's Leading Currency*, BNA Intl Bus & Fin Daily (Oct 22, 1997).

⁷² See text accompanying notes 48-49.

⁷³ One commentator argues that this adequately satisfies the CISG's call for uniform-

C. Using General Principles: Currency-Based Commercial Lending Rates

As discussed above, some adjudicators and commentators reject using the general principles of the CISG to fill the interest rate gap, reading the negotiators' explicit rejection of the formula in the CISG's predecessor as a signal that they did not want the CISG to govern this issue. However, this failure to select an explicit formula should not preclude development of a uniform solution under the CISG as economic conditions and commercial practices change.⁷⁴ While negotiators could not devise a formula to address these concerns given different national attitudes towards interest rates at the time,⁷⁵ they may be seen to have delegated to future adjudicators the task of reaching a uniform, international solution. Decisions that arrest the CISG's development in the late 1970s are thus misguided.⁷⁶

In fact, the CISG is structured so that it can adapt to changed circumstances. Professor Honnold, a U.S. representative at the negotiations, notes that Article 7 supports a dynamic interpretation of the CISG to reflect changing circumstances.⁷⁷ He argues that the general principles established by the CISG in Articles 14-88 are designed to govern a variety of transactions among diverse private parties over time and that their lack of specificity was intentional.⁷⁸ This position is bolstered by the requirement in Article 7 that adjudicators use general principles to interpret CISG provisions, as well as the incorporation of trade usages and customs permitted in Article 9, which by their nature

ity. Ferrari, 24 Ga J Intl & Comp L at 470-71 (cited in note 24).

⁷⁴ Even the rejected formula may shed some light on the negotiators' concern that delayed payments be evaluated as a breach in the contract and that creditors be adequately compensated. One commentator suggests that the initial draft proposal on interest (Article 58 of the 1976 UNCITRAL Working Group's Draft Convention) be used to interpret Article 78, concluding that it supports using the prevailing commercial rate in the injured party's country. Jeffrey S. Sutton, *Measuring Damages Under the United Nations Convention on the International Sale of Goods*, 50 Ohio St L J 737, 749-50 (1989) (predicting how damages will be measured under the CISG).

⁷⁵ See text accompanying notes 30-40.

⁷⁶ See Koneru, 6 Minn J Global Trade at 122-23 (cited in note 24) (reasoning that legislative history should be used to identify what issues were anticipated for future interpretation).

⁷⁷ Honnold, *Uniform Law for International Sales* §§ 16-21 at 60-62, § 85 at 135 (cited in note 8). He also argues that, because the CISG establishes rules that govern transactions between private parties, it should be interpreted more flexibly than one governing obligations among states. *Id.* § 103 at 158. Only obligations between states, and not those of their private citizens, are governed by the more static principles of the Vienna Convention on the Law of Treaties. *Id.* § 103.1 at 159 n 44.

⁷⁸ *Id.* § 103.1 at 160.

will change over time.⁷⁹ Finally, interpreting a treaty dynamically in light of its purposes and current circumstances is acceptable when the context in which the treaty operates changes over time.⁸⁰ Without this flexibility, the CISG could only adapt if it were renegotiated routinely.⁸¹ Despite the negotiators' difficulty in reaching a solution for Article 78,⁸² the negotiators' decision to leave the interest rate question open can be interpreted as an opportunity to make the CISG adaptable to new circumstances.⁸³

Nor are the CISG's general principles impossible to discern. Although they are not explicitly listed, the general principles are reflected both in the CISG's provisions and its foundation in general tenets of contract law.⁸⁴ One principle reflected in the CISG's damage provisions⁸⁵ that can guide determination of an interest rate is to ensure the injured party gets the benefit of the bargain, that is, putting the injured party in the position she would have been in had the breaching party performed. Professors Koneru and Honnold argue that both the treaty's text and documentary history support filling the Article 78 gap with the "benefit of the bargain" principle.⁸⁶ Other efforts to systematize international commercial transactions, such as the Principles of International Commercial Contracts drafted by International Institute for the Unification of Private Law ("UNIDROIT Principles"),⁸⁷ also adopt the benefit of the bargain principle. Additionally, the benefit of

⁷⁹ See Part I.B.

⁸⁰ See generally Edwin M. Smith, *Understanding Dynamic Obligations: Arms Control Agreements*, 64 S Cal L Rev 1549, 1557-60 (1991) (discussing how changing underlying circumstances can require flexible interpretation of treaty obligations).

⁸¹ See Honnold, *Uniform Law for International Sales* § 103.1 at 160 (cited in note 8) (noting that most if not all of the CISG provisions must serve for several decades in a world of accelerating change).

⁸² See *Decisions by Plenary Conference, 10th Plenary Meeting*, DOC C(7) (A/CONF.97/SR.10), OR 199, 223-25 (1980), reprinted in Honnold, *Documentary History* at 758-61 (cited in note 31).

⁸³ See Koneru, 6 Minn J Global Trade at 125-27 (cited in note 24).

⁸⁴ See *id.* at 115-23; Honnold, *Uniform Law for International Sales* § 99 at 152-57, § 403 at 503 (cited in note 8).

⁸⁵ CISG, Art 74 (cited in note 5). The legislative history of this article also supports this view. See *Secretariat Commentary on the 1978 Draft*, DOC C(3) (A/CONF.97/5), OR 14, 59, reprinted in Honnold, *Documentary History* at 449 (cited in note 31).

⁸⁶ Koneru, 6 Minn J Global Trade at 123-34 (cited in note 24); Honnold, *International Law for Uniform Sales* § 421 at 525-26 (cited in note 8). Koneru also observes, however, that the general principles may conflict in practice, making it difficult for a court to decide which one to apply. For example, when an adjudicator is assessing an interest award, he must not only try to provide the injured party with full compensation, but also avoid unjustly enriching him at the debtor's expense. Koneru, 6 Minn J Global Trade at 127-29.

⁸⁷ 34 ILM 1067 (1994).

the bargain is a common principle in other, non-CISG arbitrations,⁸⁸ as well as in many national legal systems.⁸⁹

Adjudicators thus can use a default rule that compensates the creditor adequately, satisfying the CISG's general principle of giving the injured party the benefit of the bargain. One way to do this would be to award a market-based commercial interest rate that applies to the currency in which payments under the contract will be made. This rule would compensate the creditor for any loss in the payment's value resulting from depreciation because depreciation is caused by inflation, for which market rates usually incorporate a premium above the real interest rate. This is also the solution proposed by Article 7.4.9 of the UNIDROIT Principles.⁹⁰ The UNIDROIT Principles represent a private organization's efforts to "legislate" common rules and practices for international contracts. However, while they can be used to supplement CISG provisions such as Article 78's interest gap, the UNIDROIT Principles have no official or binding relationship to the treaty itself.⁹¹

In several CISG-related disputes, adjudicators have used the "benefit of the bargain" principle to justify awarding a commercial lending rate. For example, in one dispute between an Austrian creditor and German debtor, the arbitrator found that the rate should be determined by the "general principles" underlying the CISG.⁹² Reasoning that Article 74, which provides for full compensation for damages, is a general principle of the CISG, the

⁸⁸ See Gotanda, 90 Am J Intl L at 57 (cited in note 42).

⁸⁹ For example, under German contract law, the objective is to put the injured party in the same position she would have been in had the injuring event not occurred. See Cromie, *International Commercial Litigation* at 255 (cited in note 50). This is also the case in France. See *id.* at 254. Several courts have awarded interest that provides full compensation, even after initially holding that the interest rate decision should be settled by national laws. See Part II.E.

⁹⁰ UNIDROIT Principles Art 7.4.9 (cited in note 87). This solution represents scholars' attempt to reconcile different national practices and thus lacks any independent legal status:

The Principles are not usages, nor can it be said that they have legislative force behind them. Certainly, some of the provisions reflect the usual manner of operating in the international commercial arena [such as the right to interest]. Others, however, could never be used in this way since they propose to reconcile varying principles and rules that derive from different legal and political concepts [such as the UNIDROIT formula for determining the interest rate].

Perales Viscasillas, 13 Ariz J Intl & Comp L at 398 (cited in note 63) (citations omitted).

⁹¹ See Garro, 69 Tulane L Rev at 1152-60 (cited in note 24) (describing relationship of UNIDROIT Principles to CISG as a set of nonbinding gap fillers).

⁹² *Parties Unknown*, Arbitral Award SCH-4318 (Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft 1994) (Wien), reprinted in *UNILEX* E1994-13 at 330 (cited in note 8).

arbitrator awarded the commonly used lending rate of the currency in which the payment would be made. He also cited Article 7.4.9 of the UNIDROIT Principles to support his claim that use of this rate was a common international practice.⁹³

This rule would be more likely than a mechanically selected statutory rate to adequately compensate the creditor. Because many international commercial transactions are financed through borrowing, the creditor may need to borrow for a longer term or may need additional financing to make his own payments if a payment is late. However, market-based commercial interest rates such as LIBOR would undercompensate less creditworthy parties who had to pay a premium when borrowing in a particular currency. Thus, when the creditor must borrow, awarding an average rate or even a preferred rate may not accurately compensate him, even though it is an easier route for an adjudicator to take.

If a creditor does not borrow, awarding the lending rate may undercompensate her when the cost to the creditor to borrow is less than her opportunity cost of funds.⁹⁴ In such situations, the rule will act as a penalty default by encouraging the creditor to contract for a compensatory interest rate *ex ante*, resulting in a more accurate outcome. Because the creditor knows whether she will need to borrow but the debtor does not, this rule will promote efficiency by encouraging the creditor to reveal that information during the negotiations.

An alternative general principle could be to avoid unjust enrichment. This principle would suggest that adjudicators analyze

⁹³ *Id.* See also *Parties Unknown*, Arbitral Award SCH-4366 (Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft 1994) (Wien), reprinted in *UNILEX* E1994-14 at 333 (cited in note 8) ("One of the general legal principles underlying the CISG is the requirements of 'full compensation' of the loss caused (cf. Art. 74 of the CISG).").

Another International Chamber of Commerce ("ICC") tribunal used the benefit of the bargain principle to award LIBOR plus a percentage to compensate the creditor. *Parties Unknown*, ICC Award No 8128/1995 (Intl Ct Arb 1995) (Paris), reprinted in *UNILEX* E1995-34 at 542.3-4 (cited in note 8). In awarding that rate, the tribunal reasoned that it was equivalent to the average lending rate to prime borrowers authorized in the UNIDROIT Principles Article 7.4.9(2). Furthermore, the tribunal concluded that the UNIDROIT Principles expressed the general principles on which the CISG was based and thus were appropriate authority to resolve the Article 78 gap. *Id.* One commentator supports this position. Garro, 69 *Tulane L Rev* at 1156 (cited in note 24) ("As long as the UNIDROIT Principles provide a solution to issues that may conceivably fall under the scope . . . of the CISG, they should be used to supplement all questions regarding the formation, interpretation, content, performance, and termination of contracts for the international sale of goods.").

⁹⁴ See text accompanying note 51 for a discussion of the opportunity cost of funds.

interest rate requests as “coerced loans.”⁹⁵ However, while this view was raised during the negotiations leading to the CISG,⁹⁶ the coerced loan theory has not been used in practice to award a creditor an interest rate that exceeds the one at which she borrowed.⁹⁷

In sum, the general principle of ensuring the injured party the benefit of the bargain, which usually leads to the selection of a commercial lending rate, would be straightforward in application. Furthermore, because most traders borrow to cover deficiencies when payments are late, it may be what most parties would contract for. Moreover, by basing the selection of the rate on the payment’s currency, it represents a more uniform international approach. However, choosing the commercial lending rate may ultimately be inefficient because less creditworthy borrowers, who must borrow at a rate greater than the commercial lending rate, will be undercompensated. Ultimately, the rule may reduce error costs by prompting both those parties and nonborrowing creditors whose opportunity cost of funds exceeds the lending rate to contract around it by specifying an interest rate in the contract *ex ante*.

D. Relying on Trade Usages: Currency-Based Commercial Lending Rates

As noted above, CISG Article 9(2) requires that trade customs be incorporated into a contract when both parties know or ought to have known of a practice that is “widely known to, and regularly observed by” others in that area of international trade. Hence a possible approach to identifying an interest rate is to look at the practice that typically prevails when parties specify interest rates in advance. Examining such practices comes close to a market-mimicking default rule because the practices reflect what parties in similar situations actually do.

Decisions following this approach usually find that trade usages point to a commercial lending rate. One court awarded a

⁹⁵ See text accompanying note 58.

⁹⁶ See *First Committee Deliberations, 34th Meeting*, DOC C(4) (A/CONF.97/C1/SR.34), OR 415, 417-18 (1980), reprinted in Honnold, *Documentary History* at 638-39 (cited in note 31). One commentator has also considered this as a general principle. See Koneru, 6 *Minn J Global Trade* at 127-29 (cited in note 24).

⁹⁷ Moreover, it is irrelevant that, in some instances, the breaching party may earn a higher rate than the injured party does. Under the efficient breach theory, the breaching party is not required to give up the gain he derives from the breach; that gain is what makes it an efficient breach. Instead, he is allowed to keep the difference between what he pays the injured party and what he gets in his alternative transaction. Similar reasoning suggests that requiring the debtor to relinquish any gains would be inefficient.

creditor the prevailing "Prime Rate" of 10 percent because it was considered a widely accepted practice in international trade under CISG Article 9(2).⁹⁸ Arbitral tribunals have also relied indirectly on trade usages. In an International Chamber of Commerce ("ICC") case involving a dispute between a Yugoslavian creditor and an Italian debtor over the sale of cow hides, the arbitrator, having ruled that the creditor was entitled to interest under Article 78, noted that there is "no single internationally accepted rate of interest."⁹⁹ Instead, he reasoned that under international law, damage due to delayed payments is commonly assumed to occur in the creditor's place of business.¹⁰⁰ He then awarded the interest rate "effective for commercial matters" in Yugoslavia.¹⁰¹

A problem with this approach is that it may be difficult for an adjudicator to obtain sufficient evidence of a custom, which may require the use of experts. Even with that evidence, the adjudicator's own subjective views may influence his perception.¹⁰² Deciding what constitutes an international transaction can complicate this effort. For instance, practices may vary regionally and by industry, suggesting that an adjudicator would need to be fa-

⁹⁸ *Aguila refractarios SA s/Conc preventivo* (Juzgado Nacional de Primera Instancia en lo Comercial No 10 1991) (Argentina), reprinted in *UNILEX* E1991-10.1 at 80.1 (cited in note 8) (awarding interest on arrears in bankruptcy case). Unfortunately, the court did not specify which "Prime Rate" it was using. Diederichsen also acknowledges that this approach is more consistent with the spirit of the CISG than is the German solution of relying on national law, which thwarts uniformity. Diederichsen, 14 *J L & Commerce* at 181 (cited in note 41). See also *Bermatex srl v Valentin Rius Clapers SA v Sbrojovka Vsetin SA*, 56.179 (Juzgado Nacional de Primera Instancia en lo Comercial No 10 1994) (Argentina), reprinted in *UNILEX* E1994-24.2 at 372.4 (awarding 12 percent "as a rate generally recognized in international trade" despite contract's mention of 9 percent figure for financing). Argentine courts rely on trade usages for other interest questions under the CISG. See also *Elastar Sacifia v Bettcher Industries Inc*, 50272 (Juzgado Nacional de Primera Instancia en lo Comercial No 7 1991) (Argentina), reprinted in *UNILEX* E1991-4 at 60 (awarding accrued interest on deferred payment because interest accrual during payment deferral is a widely known and regularly observed international trade practice).

⁹⁹ *Parties Unknown*, ICC Award No 7331 (Int'l Ct Arb 1994) (Paris), reprinted in *UNILEX* E1994-33 at 402 (cited in note 8).

¹⁰⁰ *Id.*

¹⁰¹ *Id.* However, a French court reviewing an arbitration under the CISG overturned an award based on trade usage, reasoning that trade practices are inappropriate for filling the Article 78 gap. *Thyssen Stahlunion GmbH v Maaden General Foreign Trade Organisation Building Materials* (CA Paris, 1ère ch 1995) (France), reprinted in *UNILEX* E1995-12.1 at 456.3 (cited in note 8).

¹⁰² See Richard Craswell, *Do Trade Customs Exist?* 3-6 (unpublished manuscript on file with U Chi L Rev) (1996). Conversely, in arguing for a default rule that reflects the parties' subjective intentions, one commentator assumes that identifying these customs will be a fairly easy task for the adjudicator. Randy Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 *Va L Rev* 821, 879-82 (1992) (arguing for use of customs as default rules because they generally reflect the subjective intentions of the parties).

miliar with a variety of commercial transactions to identify the appropriate custom.

The adjudicator's level of specific expertise is a significant factor. If a case is litigated in court rather than arbitrated, finding an "expert" judge is unlikely,¹⁰³ in a national court, a judge may be inclined to construe the practice through her own national perspective or misperceive the level at which the custom should apply.¹⁰⁴ Alternatively, she may rely on a local practice in the same trade. Finally, although she may agree that international customs should apply, she may choose the wrong one because she is not familiar with various possible solutions. Thus, any potential efficiencies gained by applying custom could be eroded by the increased likelihood of error. If, however, the parties agree to arbitrate, they may be able to choose an arbitrator who is familiar with their particular trade, minimizing the likelihood of mistakes.

E. Using Actual Borrowing Rates

A solution tailored to a creditor's particular needs would be to award him any borrowing costs he actually incurred. Often, this will be either the cost of an additional loan or additional interest on his line of credit. Some courts, when applying principles of private international law, have awarded the creditor his actual borrowing costs when he would otherwise have been undercompensated by the rate required by the relevant statute because that rate is less than the one at which he borrowed.

For example, a Swiss court ruling on a dispute between a Swiss debtor and an Austrian creditor awarded more than Austria's statutory rate of interest, despite its finding that Austrian law should apply.¹⁰⁵ The court observed that companies normally borrow to finance their activities and refused to award the 5 percent authorized by Austrian law. Instead the court awarded a higher (compensatory) rate, relying on Article 74 to interpret Article 78.¹⁰⁶ Other courts and commentators have reasoned simi-

¹⁰³ However, even within this category there will be variation. For example, the German court system includes specialized courts that hear only commercial cases. While the judges may not be experts in international practices, they do bring an expertise in commercial matters to the decisionmaking process. See Cromie, *International Commercial Litigation* at 177 (cited in note 50). In contrast, U.S. courts are general venues and will bring expertise only to the extent that international commercial issues have been brought before them.

¹⁰⁴ See Craswell, *Do Trade Customs Exist?* at 5 (cited in note 102).

¹⁰⁵ *Parties Unknown*, HG 930476 (Handelsgericht Zürich 1995) (Switzerland), reprinted in *UNILEX* E1995-25 at 509-10 (cited in note 8).

¹⁰⁶ *Id.* at 510.

larly when making awards.¹⁰⁷ Although one German court reasoned that awarding borrowing costs under Article 78 rather than Article 74 would eliminate the distinction between the two provisions, this reasoning is incomplete. For several reasons, Article 78 is not superfluous if one uses Article 74 to interpret it. First, the negotiators were concerned that, because national laws differed on how to treat interest on delayed payments as an element of damages, the CISG should include a separate provision to ensure that, at least for international transactions, an injured creditor would be entitled to compensatory interest when payments were delayed.¹⁰⁸ Second, as Professor Honnold suggests, because under some national laws interest does not accrue until the damage amount is certain (that is, liquidated), an injured creditor could not claim borrowing costs under Article 74 under some national laws because the amount would not be settled until the dispute was settled. This disparity, in turn, would prevent injured creditors from being treated similarly.¹⁰⁹ Third, even though adjudicators who reason this way couch their analysis in terms of national laws, in fact they are using Article 74 as a general principle through which to interpret the national laws. Thus,

¹⁰⁷ See, for example, *Parties Unknown*, HG 45/1994 (Handelsgericht St Gallen 1995) (Switzerland), reprinted in *UNILEX* E1995-30 at 530 (cited in note 8) (applying private international law and awarding German statutory rate plus additional borrowing costs); *Gruppo IMAR SpA v Protech Horst BV*, 920150 (Rb Roermond 1993) (Netherlands), reprinted in *UNILEX* E1993-14 at 241-42 (applying private international law rules and awarding statutory rate in seller's country plus devaluation losses); *Parties Unknown*, ICC Award No 7197/1992 (Intl Ct Arb 1992) (Paris), reprinted in *UNILEX* D1992-2 at 63-64 (abstract only) (deciding Austrian law governed contract and awarding Austrian statutory rate plus additional proven damages). But see *Parties Unknown*, 2 C 600/94 (Amtsgericht Wangen 1995) (Germany), reprinted in *UNILEX* E1995-10 at 445 (applying private international law rules and awarding only Italian statutory rate even though the seller proved additional costs).

In other cases, courts have commented that, had the creditor proven harm, he would have been awarded a higher rate. See, for example, *Parties Unknown*, 10 HKO 2375/94 (LG Munchen 1995) (Germany), reprinted in *UNILEX* E1995-10.1 at 445.2 (holding that Italian law governed contract under conflict of laws rules and awarding only Italian statutory rate because injured seller incurred no borrowing costs). Interestingly, the position Germany took in the CISG negotiations is reflected in its courts' decisions. The German representative argued that the injured party should be entitled to a minimum rate fixed by the CISG or by national law, but that the injured party should be able to claim additional damages if he could prove any actual injury above this minimum rate. *First Committee Deliberations, 34th Meeting, Statement of Mr. Klingsporn (Federal Republic of Germany)*, DOC C(4) (A/CONF.97/C.1/SR.34), OR 415, 416 (1980), reprinted in Honnold, *Documentary History* at 637 (cited in note 31).

¹⁰⁸ See, for example, *First Committee Deliberations, 34th Meeting, Statement of Mr. Ziegel (Canada)*, DOC C(4) (A/CONF.97/C.1/SR.34), OR 415, 418 (1980), reprinted in Honnold, *Documentary History* at 639 (cited in note 31); *Decisions by Plenary Conference, Statement of Mr. Hjerner (Sweden)*, DOC C(4) (A/CONF.97/SR.10), OR 219, 224 (1980), reprinted in Honnold, *Documentary History* at 759.

¹⁰⁹ Honnold, *Uniform Law for International Sales* § 422 at 526-27 (cited in note 8).

they arrive at the same outcome as those adjudicators who rely on the underlying principle of Article 74—that the injured party be put in the same position she would have been in had the breaching party performed—to fill the gap in Article 78.¹¹⁰

Awarding actual borrowing rates is appealing because it fully compensates the creditor.¹¹¹ In addition, it is consistent with the principle of measuring damages by substitute performance embodied in CISG Article 75.¹¹² While an adjudicator will need to police the award for reasonableness, consistent with the principle that the injured party mitigate damages under Article 77,¹¹³ this duty exists for any damage award. Using actual borrowing rates imposes additional decision costs compared to using a “bright line” rule such as an average lending rate because the adjudicator must examine the creditor’s financial records. Nevertheless, using the interest rate charged on a loan taken out specifically to replace the delayed payment more accurately approximates the time value of the payment to the creditor and requires less expertise than engaging in a review of her cost of capital. Unfortunately, this solution offers no guidance for those instances where the creditor incurs no borrowing costs but loses the use of the money, potentially undercompensating creditors who do not actually need to borrow.

III. A CUSTOMIZED SOLUTION: SAVINGS RATE IN THE ABSENCE OF BORROWING COSTS

As the discussion above demonstrates, none of the approaches currently followed fully satisfies the various objectives of a default rule. Awarding an average lending rate, such as LIBOR or a prime rate for the currency of payment, may accurately reflect the general practice in international trade of borrowing to finance transactions. However, because there are many

¹¹⁰ Honnold makes a similar point by arguing that one can consider a delayed payment in terms of substitute performance (taking out a loan) or in terms of additional borrowing from a line of credit, both of which are equal to the amount the breaching party has failed to pay. In the former case, the measure of interest is the cost of the substitute loan; in the latter, it is the rate charged (the current price) on amounts taken from the line of credit. *Id.* § 421 at 525-26.

¹¹¹ Honnold also supports this solution and reasoning. *Id.*

¹¹² The relevant part of CISG Article 75 (cited in note 5), which allows the buyer to substitute performance when the seller avoids the contract, reads: “[T]he party claiming damages may recover the difference between the contract price and the price in the substitute transaction as well as any future damages recoverable under Article 74.”

¹¹³ CISG Article 77 (cited in note 5) reads: “A party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss . . . 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.”

ways in which parties can finance an international transaction, it may not always place the injured party in the position she would have been but for the breach, either over- or undercompensating her. Relying on national laws selected by applying private international law rules may, by always applying the statutory rate in the creditor's country, achieve some procedural uniformity at the price of substantive inconsistency. Awarding the injured party her actual borrowing costs avoids many of these problems but offers no solution when the creditor does not borrow.

Adjudicators should "customize" the rate by awarding actual borrowing costs when a party incurs them, and an average investment return, such as one for a certificate of deposit for the currency in which the transaction is denominated, when the creditor does not borrow.¹¹⁴ This solution puts the injured party in the position he would have been absent the late payment by compensating him for actual out-of-pocket expenses incurred, while guaranteeing a reasonable return when he does not borrow.

Awarding actual borrowing costs would mimic what the parties would have bargained for when negotiating the contract had they recognized that the creditor would borrow to cover for the delayed payment and selected a rate. The rule is also consistent with the CISG's general principles. First, it ensures that the creditor is put in the position she would have been but for the debtor's breach by compensating her for her additional costs, consistent with Article 74, the CISG's general damage provision. Second, by using this principle from the CISG as a guide, the rule avoids using national laws to fill the gap. While some national courts have reached the same result by first determining the appropriate rate using conflict of laws rules and then adjusting the rate to match the rate at which the creditor actually borrowed,¹¹⁵ not all national laws recognize interest as an element of damages. Thus, relying on the national law approach to fully compensate the injured creditor may not guarantee this element of compensation. Third, the rule promotes uniformity in the CISG's interpretation by using the same substantive principle—ensuring the benefit of the bargain—to make awards in individual cases. Finally, because many traders do borrow when financing international transactions, awarding the cost of replacement funds re-

¹¹⁴ Gotanda proposes using a savings rate (for example, a certificate of deposit rate) for general commercial arbitration interest awards that are not governed by the CISG. Gotanda, 90 *Am J Intl L* at 59-60 (cited in note 42). Although he acknowledges that arbitrators could compensate creditors if they do borrow, *id* at 60-61, unless that rule is stated as the default, it might lead to ambiguity.

¹¹⁵ See Part II.E.

flects a common international trade practice, consistent with Article 9. In sum, it fulfills the principal objective for interpreting gaps under the CISG's Article 7: encouraging uniform and international solutions.

One might argue that ensuring an award of borrowing costs may encourage parties to borrow recklessly. However, this possibility can be policed by adjudicators, who can review the reasonableness of any borrowing that seems suspect. An adjudicator can rely on CISG Article 77, which obligates an injured party to mitigate her damages,¹¹⁶ to constrain unreasonable borrowing by requiring information on a party's creditworthiness. For example, one German court denied an Italian creditor his actual costs because they were excessive compared with other borrowing options.¹¹⁷ While this will require adjudicators to review transactions more thoroughly (thereby increasing decision costs), it may also promote the development of a common practice. Furthermore, any incentive for a creditor to borrow recklessly may be constrained by the fact that recovery of interest remains uncertain until after adjudication.

When a creditor cannot demonstrate specific substitute lending, however, she should be awarded not a lending rate, but rather a savings rate. A savings rate, such as a certificate of deposit for the currency of payment, provides a uniform way for adjudicators to settle interest rate disputes with low decision and error costs. In order to put a creditor in the position she would have been but for the breach, the court would have to award her weighted average cost of capital, which reflects the opportunity cost of her funds.¹¹⁸ In practice, however, calculating a creditor's weighted average cost of capital involves high decision costs, requiring adjudicators to synthesize an enormous amount of financial information. In contrast, a rule awarding a savings rate, such as the rate on a certificate of deposit, is easy to apply, reducing decision costs. Moreover, this rule will also reduce error costs by acting as a penalty default. If a creditor knows that she will not have to borrow to cover a shortfall caused by delayed payment, she will have an incentive to reveal this information during the negotiations. This rule will encourage her to specify in the con-

¹¹⁶ See note 113 for the text of CISG Article 77.

¹¹⁷ See *Parties Unknown*, 2 C 600/94 (Amtsgericht Wangen 1995) (Federal Republic of Germany), reprinted in *UNILEX* E1995-10 at 445 (cited in note 8). While this concern is genuine, it may be rare that a creditor, stretched for funds, will want to incur high interest costs over an indefinite period of time before litigating.

¹¹⁸ See text accompanying note 51 for a discussion of the weighted average cost of capital.

tract an interest rate that will adequately compensate her, reducing both decision and error costs should a dispute arise.¹¹⁹

It may seem objectionable to award nonborrowing creditors what will almost certainly be a lower rate than the rate awarded to borrowers,¹²⁰ but this result is compelled by the penalty default nature of the rule. If a creditor will not need to borrow, she has an incentive to select a rate *ex ante* to avoid being undercompensated by a rate lower than one reflecting her specific investment preferences—resulting in an accurate outcome. This rule is further justified because making an award based on how a party might have invested the funds (by awarding the weighted average cost of capital) conflicts with the principle that consequential damages be foreseeable under Article 74, because a breaching party cannot predict easily how the creditor would have invested the funds. The terms on which the creditor would have to take out a substitute loan, which must be ascertained in awarding borrowing costs, and the savings rate, which will be awarded in the absence of borrowing costs, are in contrast more foreseeable. When the creditor must borrow, determining a rate is a question of accounting rather than estimation.

A lending rate may in certain circumstances overcompensate the creditor at the expense of the debtor when the creditor does not borrow or where the creditor is a preferred borrower. This is because lending rates, unlike savings rates, reflect some degree of borrower risk. An average lending rate may reflect the risk of a variety of borrowers and thus may be higher than a savings rate. While doing so might deter a party from failing to pay, contract law is not based on deterrence principles.¹²¹ Instead, damage awards, by putting the injured party in the position he would have been but for the breach, allow a breaching party to evaluate when the cost of performing exceeds the benefits of breaching. He is encouraged to break the deal when doing so would be socially efficient; overcompensating the injured party here wrongfully penalizes the breacher. One could thus use a saving rate, such as a certificate of deposit, which will generally be lower than the rate

¹¹⁹ See Part I.A.

¹²⁰ For a preferred borrower with an excellent credit rating, however, the spread between the rate at which one might borrow from a bank and a basic investment instrument such as a certificate of deposit might be very small.

¹²¹ Because contract law is based not on fault but on strict liability, deterring culpable conduct is not an aim of contract law. See Knapp and Crystal, *Problems in Contract Law* at 999 (cited in note 50), citing E. Allen Farnsworth, *Contracts* § 12.8 at 874-75 (Little, Brown 2d ed 1990). Moreover, penalizing breaches would deter efficient breaches as well. See Richard A. Posner, *Economic Analysis of Law* 118-20, 128-29 (Little, Brown 4th ed 1992) (explaining concept of efficient breach and damages in contract law).

at which a creditor could borrow, to limit the likelihood that the creditor will be overcompensated if awarded an average lending rate. In fact, one commentator has suggested this solution for international commercial arbitrations not governed by the CISG.¹²²

This two part rule—awarding the savings rate in the absence of borrowing costs—avoids the problems a single solution would pose of either overcompensating or undercompensating the injured party. Moreover, the rule encourages parties who would be undercompensated to contract around it *ex ante* by specifying an interest rate in the contract, reducing error costs. Instead of promoting uniformity in the sense of an identical outcome in all instances, which simplifies decision costs but increases error costs, the solution proposed promotes a uniform objective—ensuring the parties the benefit of the bargain. It offers a uniform solution by treating similarly situated creditors consistently. In addition, it is preferable to the uniform application of a particular law, such as the creditor's, which may treat injured parties inconsistently based on nationality.

CONCLUSION

Article 78 of the CISG, while allowing for awards of interest, fails to provide explicit guidance on what interest rate should be used. Due to this gap in the CISG, adjudicators have applied a multitude of different rules to disputes arising out of international commercial transactions. Most of these rules involve applying a single uniform rate, which can minimize decision costs, but unnecessarily raises error costs. Failing to identify a uniform solution that is international in character weakens the system by: (1) undermining the legitimacy of the decisionmaking process; (2) complicating settlement by making agreement difficult when there is no solution specified by the parties; and (3) increasing costs to the parties by requiring them to spend additional resources to litigate disputes over interest.¹²³ None of these conditions promotes predictability in international commercial transactions.

The solution proposed by this Comment, awarding the lending rate in the absence of borrowing costs, would accord with the

¹²² See Gotanda, 90 *Am J Intl L* at 59-61 (cited in note 42).

¹²³ These problems are not unique to the CISG regime, but generally infect international commercial adjudication. See *id* at 55.

CISG's general principles—full compensation and uniformity—without creating unintended error costs in the search for greater predictability. As national economies continue to integrate globally, predictable, uniform, well-recognized rules not centered on the laws of individual nations become more important. By using the approach proposed here, adjudicators in international commerce can promote uniformity and international solutions to settle individual disputes.