LEGAL COSTS AS DAMAGES IN THE APPLICATION OF UN SALES LAW

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INTRODUCTION

In the literature on the uniform UN sales law (CISG), the decisions in the first and second instances of the *Zapata*[1] case triggered an extraordinarily lively discussion.[2] Simply stated, the case concerned the delivery of painted cookie tins used for packaging Christmas cookies, for which the American buyer (i.e., place of business in the USA), citing flimsy pretexts, refused to pay. The Mexican seller (i.e., place of business in Mexico), sued and was awarded compensatory damages; as part of the damages, the trial court also awarded the plaintiff its attorneys' fees. At the appellate level, where only the issue of attorneys' fees was disputed, the appellate court rejected the claim for reimbursement of attorneys' fees and reversed the trial court decision. [The seller's] appeal to the U.S. Supreme Court by writ of certiorari was denied.[3] The cases concerned the so-called "American rule," according to which the parties each bear their own litigation expenses, and in particular their own attorneys' fees, independent of the outcome of the case. This deviates from German legal understanding and has significant practical consequences. In particular, high attorneys' fees could lead to the result that the compensatory damages awarded to the plaintiff in actuality fall far short of covering his losses, and for the victorious defendant winning a case can be a pyrrhic victory. Yet, the American rule is not without exceptions, and especially for abusive lawsuits brought on obviously groundless claims, American procedural law permits the losing party bringing such claims to be partially burdened with the cost.[4] Also in cases of especially serious breach of

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1. Zapata Hermanos Sucesores, S.A. v. Hearthside Baking Co., 313 F.3d 385 (7th Cir. 2002) *available at* www.CISG-online.ch no. 684; this author reported on the trial court decision in the article *Anwaltskosten als Teil des ersatzfähigen Schadens*, PRAXIS DES INTERNATIONALEN PRIVAT—UND VERFAHRENSRECHTS [IPRax] 226-27 (2002).

2. In particular, see John Gotanda, *Attorney's Fees and Costs, Damages in International Law*, Chapter 3 (the chapter is an excerpt from a lecture series that Prof. John Gotanda is giving on international dispute resolution at The Hague Academy of International Law. He kindly provided me with the manuscript dated 21 July 2005, which is scheduled for publication in the RECUEIL DES COURS in 2007). *See also* John Felemegas, *An Interpretation of Article 74 CISG by the U.S. Circuit of Appeals*, 15 PACE INT'L L. REV. 91 (2003); Harry M. Flechtner & Joseph M. Lookofsky, *Viva Zapata! American Procedure and CISG Substance in a U.S. Circuit Court of Appeal*, 7 VINDOBONA J. INT'L COM. L. & ARB. 93 (2003); Bruno Zeller, *Interpretation of Article 74—*Zapata Hermanos v. Hearthside Baking*—Where Next?*, 1 NORDIC J. COM. LAW. 2 (2004); Jarno Vanto, *Attorney's Fees as Damages in International Commercial Litigation*, 15 PACE INT'L L. REV. 203 (2003).

3. Zapata Hermanos Sucesores, S.A. v. Hearthside Baking Co., No. 99-C4040, 2002 WL 398521 (N.D. Ill., Aug. 28, 2001), *rev'd*, 313 F. 3d 385 (7th Cir. 2002), *cert. denied*, 540 U.S. 1068 (2003).

4. *See* Schlechtriem, *supra* note 1, at 226-27.

contract, an award of punitive damages could make it possible for the victorious plaintiff to recover his litigation expenses and attorneys' fees. Nevertheless, in the large majority of cases the American rule leads to the described results, which for German jurists appear at first glance surprising and unacceptable. Especially for foreign parties to a contract who come before an American court and win, the American rule can lead to unpleasant surprises.

The decision of the appellate court was drafted by the noted judge and legal scholar Richard Posner. Judge Posner based his rejection of the recoverability of litigation expenses and attorneys' fees on the following arguments, given here in shortened and simplified form: First, the issue is a procedural question which is to be judged according to the *lex fori* and not according to the CISG. Second, if these costs are considered to be part of the damages claimed by the injured plaintiff, it would only be possible to award them to one side, namely in favor of the plaintiff entitled to damages; in contrast, the defendant who successfully defended the suit would have to bear the costs himself. Third, the legislators of the states that ratified the CISG did not envisage such a meaning for the damages norms of Arts. 74 *et seq.* CISG, and had the American legislators envisaged it they presumably would have abstained from signing the CISG rather than "abandon the hallowed American rule."

I. PARTICULAR POSITION OF THE AMERICAN RULE

A comprehensive and impressive comparative law analysis by *John Gotanda*[5] shows worldwide a large variety of solutions to the problem of litigation costs and attorneys' fees, as well as the particular position of the American rule. Generally, the following positions are distinguishable:

1. The large majority of legal systems follow the principle that the winning party is either fully, or at least partially, reimbursed for costs incurred from the proceedings.[6] However, there are significant differences with regard to the various types of costs, as well as the extent of (reimbursable) litigation costs and attorneys' fees. In determining the reimbursable costs variables include: the amount in controversy, the degree to which the claim was successful, possible delay in proceedings by a party and its general conduct, and (also) the complexity of the questions to be decided. Although requiring

5. *See* Gotanda, *supra* note 2 (manuscript on file with the author).
6. See the analysis from Gotanda, *supra* note 2 (manuscript at 1 *et seq.*, on file with the author).

the losing party to bear the costs may originally have had a punitive character, today it is only for ensuring compensation to the winning party.[7] In the European legal systems, including that of the common law, applicable procedural rules mainly shift the costs to the losing party in both state-run judicial proceedings [those provided for by the state] and arbitration. For state-run judicial proceedings the cost-bearing requirement is mostly regulated in procedural laws.[8] Although in arbitrations the parties are often first given the opportunity to come to an agreement over cost allocation, mostly however, and where such an agreement is lacking, the arbitral tribunal is allowed more or less broad discretion concerning the allocation of costs, which in most cases is apparently exercised according to the rule "costs follow the event."[9]

2. In the United States however, as previously mentioned, according to the American rule legal costs are generally not permitted to be shifted; in practice at issue are especially the attorneys' fees of the winning party.[10] The American rule is justified with the argument that the outcome of a trial often resembles a game of chance and shifting the costs would therefore unfairly penalize the losing party. Moreover, it is feared that the risk (if one loses) of being required to also bear the costs of the opposing party would prevent potential plaintiffs "from instituting actions to vindicate their rights." Finally, it is said that claims for costs and attorneys' fees would cause additional evidence difficulties and impede "the administration of justice."[11] Of course, there are significant exceptions to this rule, and in arbitration proceedings the arbitrators frequently also have the authority to allocate the costs and/or

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7. *Id.* at 5-6; HENK J. SNIJDERS, ACCESS TO CIVIL PROCEDURE ABROAD (Kluwer Academics ed., Kluwer Law International, 1996).

8. *See* Gotanda, *supra* note 2 (manuscript at 10 *et seq*., on file with the author).

9. *See id.* at 7, 44 (analysis of arbitration decisions); for Canada and South America, see *id.* at 25: In Canada the courts have discretion in assigning liability for litigation costs and attorneys' fees. In their exercise of this discretion the courts consider the conduct of the parties both before and during the proceedings as well as "the degree of success achieved." Similarly, in most Latin American countries the losing party is burdened with the costs. In Australia and New Zealand costs can generally be assigned according to the discretion of the court or arbitral tribunal, but in practice for the most part the losing party must pay the costs. *Id.* at 29. In the Asian countries the losing party is apparently required to pay the costs as well, but there are substantial exceptions with regards to the possibility of reimbursement of attorneys' fees. *Id.* at 32. Concerning the legal situation in the Middle East, where in most countries the costs can be shifted to the losing party but a distinction is often made between litigation costs and attorneys' fees. *Id.* at 36.

10. For details and further references, see Gotanda, *supra* note 2 (manuscript at 21 *et seq*., on file with the author).

11. For individual references, see *id.* at 21-22.

attorneys' fees, whereby the outcome of the proceedings is taken into consideration.[12]

3. However, one must distinguish the allocation of legal costs (including attorneys' fees) which is undertaken by a court or arbitration tribunal in its decision (or supplementary decision) within the context of legal proceedings from the indirect shifting of costs as damages; if a party incurs legal costs from trial or arbitration caused by a third party, in limited circumstances recourse may be sought against the contracting party by claiming those costs as damages: if the buyer became entangled in litigation with his customers due to defective goods, then as long as it was foreseeable he can generally—meaning insofar as not excluded under rules limiting damages such as the foreseeability rule in Art. 74 CISG—claim reimbursement for the costs of such litigation from the seller according to general rules of liability for breach of contract, despite the fact that they initially originated as legal costs. In addition, costs that arose *before* the initiation of legal proceedings may likely also be recovered as damages within the scope of application of the American rule.[13] Finally, in cases of especially reprehensible breach of contract the possible award of punitive damages for the victorious plaintiff can result in covering his legal costs.

II. RIGHT AND REALITY OF THE UNIFICATION OF LAW

A. Outer Boundaries of Unified Sales Law: Procedural Law v. Substantive Law

Uniform sales law attempts to fix its outer boundaries—i.e., its sphere of application—in Arts. 1-5 CISG, but the necessary classification of the legal institutions considered in an actual case repeatedly leads to doubts. Well-known are the problems of classifying mistakes as to the characteristics of the goods or the obligor's ability to perform as validity rules reserved for domestic law, or questions of the seller's liability or the suspension of performance due to anticipatory breach (*Unsicherheitseinrede*) unified in the CISG, but also the dividing line between public law and unified sales law in procurement by regional authorities, or also the boundary between procedural and substantive law, such as in the determination of the burden of proof or the

12. *Id.* at 23 *et seq.*
13. *Id.* at 44 (". . . they cannot be separated from other incidental damages. . . .").

agreement on jurisdiction[14] and arbitration clauses. This last boundary in particular is often fixed according to historically-based national preconceptions that have been reinforced over generations through professors and university curricula. Merely because the rules concerning cost-bearing for litigation costs and/or attorney's fees contained in domestic civil procedure codes are classified as "procedural laws" should not obscure regard for the compensatory character of such rules; this is shown by the recourse cases mentioned above, in which the legal costs are recovered as claimed damages [from the contracting party/primary obligor], and by the clear reliance on damages principles such as consideration of a successful party's joint-responsibility for the origination and scope of such costs.[15] In international cases at least, without an international uniform classification the categorization of a question as substantive or procedural can at best be a legal *façon de parler* [way of speaking] for a demarcation based on aspects of the case, but it cannot answer the substantive issue itself.

B. Legal Costs as an Excerpt from the Law Concerning Damages

Not only common sense, but also the above-mentioned possibilities to recover legal costs through recourse proceedings, or the recognition of a substantive compensation claim independent of procedural claims for reimbursement,[16] suggest that legal costs, at least those stemming from contractual disputes (in the broadest sense), represent a loss for the party that must litigate a claim since—as and to the extent such a party's success in the action shows—the other party did not fulfill (or at least did not correctly

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14. On the ineffectiveness of a classification based on the non-uniform domestic law for contractual agreement on jurisdictional clauses, compare CISG Arts. 14 *et seq.*, in particular CISG Art. 19(3) with Art. 17 (earlier) EuGVÜ [*Übereinkommen über die gerichtliche Zuständigkeit und die Vollstreckung gerichtlicher Entscheidungen in Zivil- und Handelssachen* (EC Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters)], the Lugano Convention, and Art. 23 EuGVVO [*Verordnung (EG) Nr. 44/2001 des Rates vom 22. Dezember 2000 über die gerichtliche Zuständigkeit und die Anerkennung und Vollstreckung von Entscheidungen in Zivil—und Handelssachen* (EC Regulation on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters)]; ULRICH SCHROETER, UN-KAUFRECHT UND EUROPÄISCHES GEMEINSCHAFTSRECHT, VERHÄLTNISS UND WECHSELWIRKUNGEN [UN Sales Law and European Community Law, Relationship and Interaction] § 6 ¶¶ 14 *et seq.* and 118 *et seq.* (2005).

15. In German law compare Adolf Baumbach et. al., ZIVILPROZESSORDNUNG [Commentary on German Code of Civil Procedure] § 91 ¶ 29 (63d ed. 2005), according to which the concept of "necessary costs" in § 91 I 1 ZPO [*Zivilprozessordnung* (German Code of Civil Procedure)] expresses a substantive duty to mitigate damages.

16. *See id.* ¶¶ 43 *et seq.* (overview to § 91 ZPO).

fulfill) their contract. However, it is questionable whether these "special damages"[17] and their recoverability are in fact uniformly regulated on the basis of Arts. 74-76, 77 CISG (or should be resolved uniformly through interpretation of these provisions on the basis of Art. 7(1) CISG respectively, especially with regard to the promotion of uniformity in the application of the CISG),[18] even if that would result in an open conflict with diverging views—in particular the American rule—but also with other rules for calculating damages in domestic procedural laws.[19] European courts have occasionally thus held.[20] At first glance the points made above and also emphasized by Judge Posner regarding the one-sidedness of reimbursement for litigation costs speak against such an understanding or such an interpretation of Art. 74 CISG in particular, since reimbursement can only be awarded to the prevailing plaintiff.[21] One should not respond to this with the presumption, possible through German interpretation methods, of a counterclaim for damages on the part of the successful defendant due to breach of a contractual duty of loyalty. Also, the possibility that claims for litigation costs or other legal costs asserted in recourse proceedings [against the original contracting party] are reimbursable as damages[22] cannot fully dispel the argument of the one-sidedness for the core range of cases, and at most demonstrates a further coincidence concerning reimbursement of legal costs. In my opinion, the argument emphasized by Posner regarding the lack of intent to ratify the Convention on the part of the national legislators who

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17. The German concept of damages, shaped by the "difference theory" which only knows items of a uniform claim for damages but not individual items of damages as basis for corresponding damages claims, naturally resists special treatment of particular damages items; whether it can claim application for the interpretation of Arts. 74-77 CISG is highly doubtful and cannot be further investigated here.

18. Such is the argument of Zeller, *supra* note 2.

19. *But see* Gotanda, *supra* note 2 (manuscript at 66 *et seq*., in particular sub 4.6-4.7, on file with the author) (as a counterargument refers also to the possible divergences between the amount for reimbursement claims fixed in the procedural laws, such as according to the amount in controversy, and the calculation as damages).

20. *See* AG Augsburg [Petty District Court], Jan. 29, 1996, (BRAGO) *Bundesgebührenordnung für Rechtsanwälte* (Federal Regulation on Attorneys' Fees) (F.R.G.), *available at* www.CISG-online.ch no. 172; http://cisg3.law.pace.edu/cases/960129gl.html; AG Berlin-Tiergarten [Petty District Court], Mar. 13, 1999, IPrax 172 (1999) (F.R.G.) *available at* www.cisg-online.ch no. 412; LG Berlin [District Court], Mar. 21, 2003, *available at* www.cisg-online.ch no. 785); Turku Court of Appeal, 12 Apr. 2002 (Finnish) *available at* www.cisg-online.ch no. 660; Tribunal Cantonal Vaud [Canton Appellate Court], Mar. 11, 1996 (Switz.) *available at* http://cisg3.law.pace.edu/cases/960311s2.html.

21. Upon a closer look, one-sided cost shifting possibilities for (only) the plaintiff remain, such as those possibilities mentioned in the text to claim the costs of pursuing a claim before or outside of trial, shifting legal costs by asserting them as damages in recourse proceedings against the primary obligor, as well as the award of punitive damages.

22. See the above comments, *supra* note 21.

signed it into law carries great weight. Certainly, one cannot always allow further development in conformity with Art. 7(1) CISG and gap-filling through uniform rules according to Art. 7(2) CISG to fail simply because the national legislators did not foresee something and consequently did not consider it in ratification, since in the main the ratifying or authorizing national organs did not consciously evaluate the details of the CISG in full knowledge of their meaning and consequences anyway. But with such deeply-rooted rules of domestic law such as the American rule, the argument that the United States would not have ratified the Convention if the consequence of abandoning of the American rule in international cases was openly addressed carries significant weight. Therefore, it is important not to lose sight of the practical consequences of the plausible notion that legal costs are or can be losses for the successful plaintiff. Yet, since this point [that reimbursement of costs is not available] can be considered as established in American jurisprudence,[23] it is unlikely that American courts would in the future follow a different academic opinion, however convincingly reasoned it might be. Maintaining such a different opinion (i.e., holding "litigation costs as special damages" to be reimbursable under Art. 74 CISG) in the hopes of influencing the American courts would be like trying to wag the dog with the tail, or even with just the fur of the tail; consequently it should no longer be earnestly asserted or followed.

III. PARTY DECISIONS AND COST RISKS

1. The view that the allocation of legal costs is a damages law question seems to invite application of the damages norms of the CISG to these costs and thereby create an unavoidable conflict with the American rule. In my opinion though, this can be reconciled with the damages provisions of the CISG in such a way that a collision is avoided: the decision on this issue should, in my opinion, ultimately be made by the market (see para. 2 below).

A principle of the CISG underlying the rules of responsibility for breach of contract is the principle (expressed in various provisions) of the assumption of risks which at the time of the conclusion of the contract were foreseen or reasonably should have been foreseen. This applies for judging whether a

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23. For other cases besides *Zapata* where reimbursement of attorneys' fees was denied because it was viewed as a question of procedural law and consequently Art. 74 CISG was not applicable, see Ajax Tool Work Inc. v. Can-Eng Mfg. Ltd., 2003 WL 223187, at *7 (N.D. Ill. Jan. 30, 2003); Chicago Prime Packers v. Northam Food Trading, 320 F. Supp. 2d 702, 716 (N.D. Ill. 2004), *available at* http://cisgw3.law.pace.edu/cases/040521u1.html.

breach of contract was a fundamental breach or not under Art. 25 CISG, for the counter-exception to an obligor's exemption of liability for a failure to perform due to an impediment beyond his control under Art. 79(1) CISG,[24] and particularly for the extent of permitted damages under Art. 74 CISG, second sentence. Whoever enters into a contract in the face of known or recognizable risks that could cause him financial losses and fails nonetheless to limit or disclaim these risks through appropriate provisions in the contract, bears them himself. For compensable losses this applies not only for the extent of the damages foreseeable as a possible consequence of the breaching party's *own* breach, but also, in my opinion, for certain damages being not recognized as compensable or not available in certain countries, to the detriment of the obligee. In other words, whoever brings or is drawn into contract disputes before an American court thereby assumes the risk of having to bear his own legal costs (court costs and attorneys' fees) according to the American rule, regardless of the outcome of the legal dispute.[25] The parties may attempt to control this risk through clauses on cost-bearing in the contract. In particular they should contemplate avoiding the American rule through the use of choice of forum clauses that lead to jurisdictions with procedural rules allowing broad reimbursement of costs, or through the choice of arbitration proceedings whose rules provide for, or at least allow, cost allocation.[26]

2. Dispute resolution is offered as a service by various institutions—state-run courts, arbitration organizations, and mediators—which are in competition. Indeed, on the international level arbitration institutions, which compete among themselves and with state-run courts, offer to render such

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24. There is no exemption of the contract obligor's liability if at the time of conclusion of the contract he foresaw an impediment beyond his control (i.e., an impediment actually capable of exempting liability) or would "reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract" but nonetheless entered into the contract.

25. Of course, the same applies to proceedings before courts other than American courts or before arbitration tribunals which, according to their procedural rules, only permit the losing party to be partially burdened (i.e., not in the full amount of the costs incurred in the proceedings by the plaintiff) or only according to [the judge's] free discretion.

26. For other—additional—reasons for avoiding American jurisdiction, see Hein Kötz, *Der Einfluß des Common Law auf die internationale Vertragspraxis* [The Influence of the Common Law in International Contract Practice], *in* FESTSCHRIFT FÜR ANDREA HELDRICH 771-80 (Werner Lorenz ed., 2005), *reprinted in* HEIN KÖTZ, UNDOGMATISCHES [Undogmatic], 158 (Jürgen Basedow et al. eds., 2005). On behavior regulation or alternative behavior due to legal norms, see Hein Kötz, *Geschäftsführung ohne Auftrag aus rechtsökonomischer Sicht* [Agency Without Authority as Viewed from an Economic Perspective], *in* FESTSCHRIFT FÜR BERNHARD GROßFELD 583-97 (Ulrich Huber & Werner F. Ebke eds. 1999), *reprinted in* HEIN KÖTZ, UNDOGMATISCHES [Undogmatic], 560-61 (Jürgen Basedow et al. eds., 2005).

services in many countries, in particular for disputes arising from international contracts. Insofar as there is freedom of contract for dispute resolution agreements—which for international commercial contracts in the largest trading nations is (still) mostly the case—the parties can also choose their cost regime and thereby also decide whether, through jurisdiction or arbitration clauses, they wish to avoid application of the American rule for their contract disputes.[27] Therefore, on a fairly long-term basis this market could and should also decide which cost-bearing rule contracting parties in international commerce esteem "correct."[28]

Contractual arrangements for dispute resolution, and thus also for the allocation of potential costs, naturally require the collaboration of the other party, which will not always be attainable, especially so long as and to the extent there is no transparency with regard to costs and their allocation (i.e., with regard to the conditions of the market for these services). Moreover, ingrained convictions as to the superiority of one's own system of dispute resolution or even just the greater familiarity with its rules may relativize the significance of consequences that follow possible cost allocations. Nonetheless, it is hoped that the market gives hints as to which rule is actually economically more efficient for individual parties and for that reason at least, "more correct." A certain dogmatic preconception of damages in the CISG should at any rate not prevent that.

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27. That this will not permit avoidance of all danger of lawsuits and the sulting cost risks from business activity in the USA, especially from the sale of goods with product liability potential, need not be explained here.

28. Taken loosely from Paul Samuelson, the "Nestor" of economics in the USA and Nobel Prize winner, economics allows bad legal rules to become irrelevant: "I don't care who writes a nation's laws—or crafts its advanced treaties—if I can write its economic textbooks," *quoted in* James Surowiecki, *Class Action*, THE NEW YORKER, Nov. 7, 2005, at 46. Similar quotations from the founding fathers of the economic analysis of the law could easily be added, and Richard Posner must have looked favorably upon the prospect that the application of the American rule to international contracts, which he established as judicial precedent in the *Zapata* case, could be pushed aside by the global market for the service "dispute resolution." Of course it remains open—and may well be hardly ascertainable—whether the total social welfare is not increased by cost rules which prevent litigation through their allocation of the cost burden; here a cost rule that enables reimbursement of costs for the winning party of a lawsuit is consequently accepted as "correct."