

FIFTH INTERNATIONAL ARBITRATION AND
NEGOTIATION MOOT COMPETITION

MEMORANDUM FOR RESPONDENT



KYUSHU UNIVERSITY

BLUE ELECTRONICS, INC.

ARBITRIA

CLAIMANT

RED INDUSTRIES, CO.

NEGOLAND

RESPONDENT

EXECUTIVE SUMMARY

I. THE PURPLE INCIDENT

1. On 1 April 2001, Red Industries Co. ("Red") and Blue Electronics Inc. ("Blue") entered into a five-year Supply Agreement (the "Supply Agreement") that governed the supply of Model PB-3 ("PB-3") and Model YR-5 ("YR-5") large-scale integrated circuit ("LSI") units manufactured by Red exclusively for Blue. On 21 August 2006, Blue placed a written order for the supply of 30,000 YR-5s to be delivered by 5 September 2006 (the "Order"). On that date, 30,000 YR-5s were delivered to and accepted by Blue.
2. However, when Blue placed the Order, it incorrectly specified YR-5s on the order form. Upon realizing its mistake when the YR-5s were delivered, Blue placed another written order for the supply of 30,000 PB-3s on 6 September 2006 (the "September Order"). These PB-3s were delivered to Blue on 30 September. Blue accepted this delivery but failed to pay the agreed purchase price of 300 million Arbs.
3. Red is not liable for any of Blue's losses. Under the terms of the Supply Agreement, all orders for PB-3s or YR-5s are to be made in writing. The written order of 21 August 2006 specified YR-5s. As a result, Blue was unable to meet its contractual obligation to Purple Mobile Co. ("Purple") to supply 30,000 mobile phones requiring PB-3s. Due to this error, Blue was forced to compensate Purple for its losses in the sum of 300 million Arbs and is now attempting to set-off that amount against moneys owed by Blue to Red. However, Red acted in good faith and in accordance with its contractual duties in filling the Order, and therefore, is not liable to Blue for any amount.
4. In the alternative, should Red be found liable, such liability should be limited to the damage it actually caused. Blue was grossly negligent in placing the

erroneous Order. Such gross negligence substantially caused Blue's own loss. Thus, pursuant to Article 7.4.7 of *UNIDROIT*¹, Blue should share in any liability to the extent of its contribution to the harm. Furthermore, Blue failed to mitigate its damages as required by Article 7.4.8 of *UNIDROIT*. This lack of mitigation further limits the extent of any liability that may be apportioned to Red.

II. THE YELLOW INCIDENT

5. On 1 September 2005, Blue and Yellow Phone Ltd. ("Yellow") entered into a Joint Development Agreement (the "Blue-Yellow Agreement") to develop Model X. Accordingly, on 1 November 2005, Blue and Red entered into a joint technology agreement (the "JT Agreement") for the development of Model X LSIs. Both agreements had comprehensive confidentiality provisions, however, the Blue-Yellow Agreement stipulated liquidated damages in the sum of 500 million Arbs should there be any breach of confidentiality. The JT Agreement contemplated the secondment of Mr. Orange ("Orange"), an employee of Blue, to supervise the Model X LSI development project (the "Project") in cooperation with the project leader of Red, pursuant to the Employee Secondment Agreement (the "Secondment").
6. After Orange prepared a progress report (the "Report") at the request of Blue, on his own time and outside of Red's premises, Confidential Information (as defined in the JT Agreement) relating to Model X leaked over the internet (the "Leak"). As a result of the Leak, Blue paid Yellow the sum of 500 million Arbs out of court to settle the latter's claim for liquidated damages. Blue is now trying to recover this loss from Red.

¹ *UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS*, 1994 ("UNIDROIT").

7. However, Red should not be liable for such loss. Not only was Orange acting outside of the scope of the JT Agreement and the Secondment, and in Blue's sole interests when the Leak occurred, he was acting in direct contravention of Red's established and reasonable security measures.

8. However, in the alternative, should Orange be found to have been acting within the scope of the Secondment, or should Red's security measures be deemed inadequate, Red should not be held fully responsible for Blue's losses pursuant to Article 7.4.7 of *UNIDROIT*. Orange prepared the Report solely for Blue without the knowledge, cooperation or participation of Red. In doing so, he violated Red's security policies under unsafe circumstances. Thus, Blue, acting through Orange, contributed materially to the risk leading to the Leak. Pursuant to Article 7.4.7 of *UNIDROIT*, and in light of the allocation of control over Orange in favor of Blue under the Secondment, Blue should bear at least two-thirds of the liability for its loss.

DISCUSSION - THE PURPLE INCIDENT

I. CONTRACT

A. THE SUPPLY AGREEMENT IS A REQUIREMENTS CONTRACT

9. The Supply Agreement is a requirements contract.² Under this agreement, Red agreed to supply PB-3s and YR-5s, and Blue agreed to purchase the same according to its actual needs during the Supply Agreement's term. Given the large volume of LSIs moving between the two companies, the Supply Agreement was intended to simplify the previous practice of preparing a new contract for each individual transaction. The Supply Agreement provides a clear, consistent and contractually-based ordering process that Red and Blue are obliged to follow.

B. ORDERS SHOULD BE IN WRITING

10. Article 1(1) of the Supply Agreement clearly requires orders to be made in writing, stating the product number, quantity and delivery date, along with the signature of an authorized signatory for Blue. This writing requirement can only be waived or amended by the written consent of both parties pursuant to Article 5(3) of the Supply Agreement. To date, Article 1(1) has not been amended or waived in writing pursuant to Article 5(3), thus the general requirement to send written orders remains valid³.

² A "requirements contract" is "a contract in which a seller promises to supply all the goods or services that a buyer needs during a specific period and at a set price, in which the buyer promises (explicitly or implicitly) to obtain those goods or services exclusively from the seller": Blacks' Law Dictionary, 1999, p. 324.

³ ICC International Court of Arbitration Zurich, Case No. 9117. ICC International Court of Arbitration Bulletin, Vol. 10, No. 2, Fall 1999, pp. 96-101.

11. Red's General Manager ("GM") reiterated this requirement on 21 August 2006 by instructing that a written order be sent "as usual".⁴ Blue complied with this request and the Order was faxed shortly thereafter.

C. WRITTEN ORDERS PREVAIL

12. Once Blue complied with the requirement to send a written order, Article 1(2) of the Supply Agreement obligated Red to act in good faith, and exert all "commercially reasonable efforts" to supply the goods indicated therein (i.e. 30,000 YR-5s) at the cost of 10,000 Arbs per unit by the date required. In filling the Order by 5 September 2006, Red acted in accordance with the terms of the Supply Agreement. Hence, Red is not liable for any losses sustained by Blue.
13. Furthermore, the intention of the parties to be bound by the requirements of Article 1(1) of the Supply Agreement can be illustrated by a previous transaction between Red and Blue. Red discovered a mistake in one of Blue's orders with respect to the LSI unit description. However, in spite of recognizing that an error had been made, Red acknowledged that it had no authority to unilaterally change the content of the order. Consequently, Red required Blue to submit a new written order form, duly signed, and specifying the correct LSI. Thus, written orders prevail and Red was obligated to rely on and comply with the Order as sent.

⁴ See *UNIDROIT*, *supra* note 1, at Article 4.3(b).

II. DAMAGES

14. In the event that Red is found liable, such liability should be limited in scope to damages actually caused by Red, and to the losses actually suffered by Blue.

A. BLUE WAS GROSSLY NEGLIGENT IN PLACING THE MISTAKEN WRITTEN ORDER

15. The Order erroneously described the LSI required: Blue needed PB-3s, but mistakenly ordered YR-5s. In addition, the Order was sent by fax. Yet, in spite of ample opportunity to do so, and knowing that Red's GM would be out of the country, Blue failed to verify this fax, and the mistake was left undiscovered. Blue had every opportunity in the two weeks between the placement of the order and delivery of the YR-5s to rectify its mistake, but did not. Red produced and delivered the goods requested by the Order. In contrast, the acts and omissions of Blue constituted *gross negligence*.

16. International Tribunals applying *UNIDROIT* have found that gross negligence is an elementary failure of attention to the consequences of one's actions that leads to a performance substantially different from what the other party reasonably expected.⁵ Blue's acts and omissions were grossly negligent in that it failed to specify the correct LSI—the most basic requirement of any order between Blue and Red—and failed to notice this mistake for two weeks in spite of the importance and urgency of the Order.

17. Blue is attempting to avoid its contractual obligation under the Supply Agreement to pay Red for the September Order, which was placed upon discovery of Blue's original error. According to Article 3.5(2)(b) of *UNIDROIT*, a party cannot avoid a contract because of mistake if it was grossly negligent in

⁵ Arbitral Award of No. 5835 ICC International Court of Arbitration (Rome), June 1996.

committing such mistake. Thus, by attempting to avoid payment for the September Order in response to the damage Blue suffered due to its own gross negligence, Blue is trying to avoid the Supply Agreement in contravention with *UNIDROIT*.

B. BLUE IS LIABLE FOR A SUBSTANTIAL PORTION OF THE DAMAGES

18. According to the above arguments, Blue's gross negligence was the substantial cause of its own losses. Article 7.4.7 of *UNIDROIT* provides that,

Where the harm is due in part to an act or omission of the aggrieved party or to another event as to which that party bears the risk the amount of damages shall be reduced to the extent that these factors have contributed to the harm, having regard to the conduct of each of the parties.

19. Blue should be liable for at least 75% of the damages, as Blue substantially caused those damages. Thus, Red's liability should accordingly be reduced to a maximum of 25%.

C. BLUE FAILED TO MITIGATE ITS LOSSES

20. Red should only be required to contribute to damages that would have been awarded if Blue had fulfilled its obligation to mitigate as required by Article 7.4.8 of *UNIDROIT*. Blue failed to mitigate when it rejected Purple's initial settlement proposal for the sum of 200 million Arbs. Blue imprudently entered into arbitration, the outcome of which was uncertain, in total reliance on one lawyer's advice, and without seeking a second opinion. The arbitrator then awarded 300 million Arbs to Purple. By refusing to settle, Blue failed to mitigate its damages by at least 100 million Arbs.

D. COMPUTATION OF DAMAGES

a. The Settlement: Quantum

21. Based on the above-mentioned facts, if Blue had reasonably negotiated with Purple, damages could have been reduced to at least 200 million Arbs. This sum should thus be the starting point from which any liability of Red is calculated.

b. Apportioned Profit Gained from the Sale of the YR-5s to Yellow

22. Contemporaneous with the Purple Incident, Blue received an order for YR-5 phones from Yellow and was therefore able to utilize the 30,000 YR-5s incorrectly ordered on 21 August 2006. Moreover, Blue profited from the sale of these units. In order to avoid overcompensation of an aggrieved party, damages must be reduced to the actual loss suffered⁶. Therefore, pursuant to Article 7.4.2 of *UNIDROIT* Blue's profit should be taken into consideration in determining its actual loss, which should be reduced accordingly.

⁶ *Sapphire International Petroleum v. National Iranian Oil*, ILR 1963, 136, 185 *et seq.*

DISCUSSION - THE YELLOW INCIDENT

I. JOINT TECHNOLOGY AND EMPLOYEE SECONDMENT AGREEMENTS

A. THE PREPARATION OF THE REPORT FOR BLUE WAS NOT WITHIN THE SCOPE OF THE JT AGREEMENT AND THE SECONDMENT

23. The presence of Orange at Red's facility is attributable solely to the JT Agreement and the Secondment. Hence, his acts must be examined with close reference to the scope and purpose of these agreements.
24. Blue claims that the Leak occurred while Orange was under the management of, and in the course of work for, Red. However, the scope of the Secondment was limited to supervising the Project in cooperation with the project leader of Red.⁷
25. The Report, however, was prepared at Blue's request, and solely for Blue's purposes (the board meeting of 14 September 2006). It was prepared without the knowledge, cooperation or participation of Red, and was an act beyond the scope and purpose of the Secondment and the JT Agreement. It was in no way an act made under the management of, or in the course of work for, Red. Thus, Red cannot be held liable to Blue for the conduct of Orange.

B. RED COMPLIED WITH ITS CONFIDENTIALITY OBLIGATIONS TO A REASONABLE STANDARD

26. In the event the preparation of the Report is found to be within the scope of the Secondment, Red nevertheless complied with its obligations under the JT Agreement by taking all reasonable actions to protect Confidential Information, and providing all reasonably required security procedures at its facilities and in connection with its business activities.

⁷ Intercollegiate Negotiation Competition Newsletter Vol. 5, No. 2 (2006) ("Newsletter No. 2"), at p. 4; Problem for the Fifth Annual Intercollegiate Negotiation Competition ("Problem"), at para. 20.

27. Article 16(1) of the JT Agreement requires each party to take only “reasonable actions” to protect Confidential Information. Similarly, Article 16(2) requires each party to perform only “reasonably required” security procedures at its facilities and in connection with its business activities to protect such information. These provisions clearly reflect the parties’ intention to provide for an objective standard by which to measure compliance. Thus, Red’s actions are to be measured against nothing more than a reasonableness standard.
28. In this case, Red took all reasonable actions and procedures to protect Confidential Information. Red instituted information management regulations within its facilities, including prohibiting the use of personal computers for the preparation of company documents,⁸ and the removal of internal documents from Red’s premises.⁹
29. In addition, Red established security policies, conducted employee education and training on these policies, revised its management structure and made regular internal security inspections. These measures were implemented in accordance with the Negolandic Ministry of Trade and Industry’s information security guidelines for the manufacturing industry (the “Guidelines”).¹⁰ Negoland is a highly industrialized nation with a focus on high-tech industry.¹¹ Thus, with respect to information security, the Guidelines must be regarded as being on par with international practice. Red’s adherence to these Guidelines clearly indicates Red’s commitment to high standards of information security.

⁸ Problem, *ibid.* at para. 21.

⁹ *Ibid.*

¹⁰ Newsletter No. 2, *supra* note 7, at p. 9.

¹¹ Problem, *supra* note 7, at para. 1.

30. Blue could not have been unaware of Red's security measures at the time the parties entered into the JT Agreement. Hence, Blue itself recognized the adequacy – *the reasonableness* – of these measures by requiring Orange to comply with Red's office regulations under Article 5 of the Secondment. Had Blue been unsatisfied with the reasonableness of Red's measures, Blue should have either required Orange to adhere to another security standard (i.e. one preferred by Blue), or at least notified Red of its concerns.
31. Moreover, on at least two separate occasions, and in compliance with Red's regulations, Orange prepared and sent similar progress reports to Blue without any leak of Confidential Information.¹² Thus, Red was given no reason to believe its security measures were inadequate. Until the time of the Leak (occurring after a breach of Red's security policies), Red's security measures had effectively protected all Confidential Information. Therefore, Red could not be expected to institute more draconian measures, such as inspecting the bags of its employees.
32. Therefore, Red's security measures were reasonable, and in compliance with the JT Agreement at all times. Accordingly, Red is not liable to Blue.

¹² Intercollegiate Negotiation Competition Newsletter Vol. 5, No. 1 (2006), at p. 5.

II. DAMAGES

A. BLUE CONTRIBUTED MATERIALLY TO ITS LOSSES, THEREBY REDUCING THE EXTENT OF RED'S LIABILITY

33. In the event Red is deemed to have breached its obligations under the JT Agreement, according to Article 7.4.7 of *UNIDROIT*, Blue cannot recover to the extent that it contributed to its loss.

a. Blue Failed to Take All Reasonable Actions to Protect Confidential Information

34. Blue, acting through Orange, failed to take all reasonable actions to protect Confidential Information of Blue and Red in breach of Articles 16(1) and (2) of the JT Agreement. In preparing the Report, Orange was acting solely in Blue's interest and was subject to Blue's direction. Orange prepared the Report in his home, based on internal documents removed from Red's premises, in gross violation of Red's security policies.

35. Furthermore, there was sufficient notice and time for Orange to prepare the Report in compliance with Red's information management procedures. Red's office closure of 10 September 2006 was posted prominently on its employee information board for two weeks.¹³ If Orange urgently needed to use a computer during this period, he should have asked Red to provide him with an alternative. His preoccupation with other matters did not excuse him from compliance with Red's policies. In fact, in preparing Blue's report, Orange acted recklessly and was willfully blind to the repercussions of violating Red's security measures. A

¹³ Intercollegiate Negotiation Competition Newsletter Vol. 5, No. 3 (2006), at p. 8.

reasonable person would have been aware of the notorious harm caused by file exchange software, as widely reported in the media.¹⁴

36. In the face of apparent risk, Orange acted in gross violation of Red's policies, and caused the Leak. By directing Orange to prepare the Report, Blue must be held responsible for Orange's actions.

b. Any Damages Owed by Red are Reduced to the Extent that Blue Contributed to the Creation of Risk of Information Leakage

37. Red was unaware of the necessity of the Report.¹⁵ Furthermore, Orange did not disclose to Red his difficulty in preparing the Report before 10 September (the day of the Red office closure). This lack of information rendered it impossible for Red to accommodate Orange, and to take additional steps to protect the security of Confidential Information.

38. Therefore, Blue's failure to disclose relevant information increased the risk of information leakage and it is to this extent that Blue cannot claim damages against Red.

c. Liability for the Leak should be Apportioned in accordance with the Secondment

39. The Secondment does not expressly state which party, Blue or Red, should bear responsibility for the actions of Orange during the secondment period. However, in apportioning liability for the Leak between the two parties, reference must be had to the terms of the Secondment.

¹⁴ Problem, *supra* note 7, at para. 1.

¹⁵ Newsletter No. 2, *supra* note 7, at p. 8.

40. The Secondment indicates that, as Blue's representative, Orange was predominantly under the control of Blue: (1) Blue remained responsible for Orange's holidays, benefit package, and severance (Article 5); (2) Blue paid Orange his salary and bonuses directly (Article 6); (3) Blue remained responsible for Orange's health, pension, and employment insurance (and made financial contributions accordingly) (Article 7); and, (4) Blue paid Orange for all his commuting costs while working at Red's facility (Article 8.2). These provisions clearly indicate that in spite of Orange's "leave of absence", Blue exercised significantly more control over Orange than Red.
41. In contrast, pursuant to Articles 7 and 8, Red's responsibilities towards Orange were limited to the payment of worker's accident insurance premiums and work related expenses. This "responsibility" was not reflective of Red's control over Orange, but rather of the contractual allocation of expenses as between Red and Blue related to the Project, while Orange was on Red's premises.
42. Taking the above into consideration, as well as the fact that the Report was prepared solely for Blue's purposes, at least two-thirds of any liability for the Leak should be borne by Blue pursuant to Article 7.4.7 of *UNIDROIT*.