FUNDAMENTAL ALTERATION OF THE CONTRACTUAL EQUILIBRIUM UNDER HARDSHIP EXEMPTION

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Abstract. The authors of this article apply systemic and comparative methods in order to discuss the key criteria of hardship as a legal institute, i.e. a fundamental alteration of the contractual equilibrium. The authors focus on modern regulations, such as those established in the Principles of International Commercial Contracts and other international contract restatements. The UNIDROIT Principles and other legal instruments usually quite abstractly define the criterion of fundamental alteration; thus further input is necessary in order to reveal the more precise requirements of hardship. The authors of this article provide such an input by conducting a comparative research of the most prominent legal doctrine and case law.

Keywords: hardship, changed circumstances, fundamental alteration, alteration threshold, contractual equilibrium.
Introduction

Most states have established special provisions in their statutory instruments dealing with changed circumstances in contract law, addressing them as hardship, clausula rebus sic stantibus, Wegfall der Geschäftsgrundlage, imprévision, frustration of purpose, impracticability etc.¹ In some countries, such as Austria², Spain³, Switzerland⁴, Romania⁵, and Turkey⁶, the principle of hardship or its equivalent has been recognised by the courts. The principle has also been established in well known soft law legal instruments such as the UNIDROIT Principles of International Commercial Contracts (hereinafter – UNIDROIT Principles)⁷, the Principles of European Contract Law (hereinafter – PECL)⁸, the Draft Common Frame of Reference (hereinafter – DCFR)⁹, the ‘TransLex Principles’¹⁰, etc. Despite the significant differences among the various hardship provisions on both national and international levels, the very essence of the hardship exemption suggests that hardship may arise due to certain events in the course of the performance of contract which cause disequilibrium between the parties. This disequilibrium may have two different effects: an increase of costs of performance, or a diminution of the value of the performance. However, legal instruments and official commentaries only rarely quantify or otherwise address the required disequilibrium in exact numbers or provide other straightforward criteria. This is mostly left to courts and arbitral tribunals: the assessment is only made on a case-by-case basis.

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¹ For a more detailed overview please see Baranauskas, E.; Zapolskis, P. The Effect of Change in Circumstances on the Performance of Contract. Jurisprudence. 2009, 4(118): 197–216. For the sake of clarity the authors of this article mostly refer to the changed circumstances exemption as “hardship” since this term is established in the UNIDROIT Principles of International Commercial Contracts and reflects the international character of this legal doctrine.


⁶ Ibid.


The main purpose of this article is to examine the requirement of “fundamental alteration” (contractual disequilibrium) more closely. This analysis is relevant both on national and international level. It is important on national level, for example, where the rules on hardship contained in the UNIDROIT Principles have been adopted or almost literally transposed into national legislation, such as the Civil Code of the Republic of Lithuania. Therefore, revealing the contents of the fundamental alteration criterion under the UNIDROIT Principles may assist to better understand this criterion and properly apply it in Lithuania. A few publications in Lithuania have dealt with hardship as a legal institute\textsuperscript{11}, but so far no articles or monographies have been published in Lithuania which would provide an in-depth analysis of the relevant criteria. But the analysis may also help shed more light on the interpretation of hardship on an international level because in legal doctrine this issue often does not get the attention it deserves.

1. Contractual Disequilibrium under Hardship Exemption:
   General Remarks

First of all, it must be mentioned that in case of changed circumstances it is not the unforeseen event which determines the hardship situation; rather the event creates the factual basis for hardship to arise but not the hardship as such. This means that the disadvantaged party who wishes to use the hardship exemption must provide relevant evidence to demonstrate how certain changed circumstances would influence the debtor's ability to perform the specific contract. For example, a tenant cannot initiate renegotiations or request the court to reduce rent payments by reasoning only that due to the world financial crisis the rent prices have generally decreased. A party is also not entitled to use the hardship exemption only because the contract turned out to be less profitable than expected at the time of conclusion of the contract. Let us shortly analyse how the main requirement for hardship, namely the contractual disequilibrium, is presented in soft law legal instruments.

Various legal instruments use different terminologies to define the contractual disequilibrium. The UNIDROIT Principles set forth that ‘there is hardship where the occurrence of events fundamentally alters the equilibrium of the contract’\textsuperscript{12}. Conversely, PECL do not use the terms ‘hardship’ or ‘equilibrium of the contract’ but rather set forth that in order to invoke the exemption of changed circumstances, the performance must become ‘excessively onerous’\textsuperscript{13}. This term is to be distinguished from the ‘more onerous performance’ (Article 6:111(1) of PECL) which does not entitle a party to any relief. According to some authors, the requirement of ‘excessively onerous

\textsuperscript{12} Article 6.2.2 of the UNIDROIT Principles.
\textsuperscript{13} Article 6.111(2) of the PECL.
performance’ well reflects the essence of the doctrine, whereas the requirement of ‘fundamental alteration’ as established in the UNIDROIT Principles bears the risk of being abused\textsuperscript{14}. However, the commentators of the UNIDROIT Principles suggested that the requirement of ‘excessively onerous’ performance is implicitly incorporated within the requirement of ‘fundamental alteration’\textsuperscript{15}. The requirement of ‘excessively onerous’ performance is also established in the ICC Hardship Clause 2003\textsuperscript{16} (model clause that may be incorporated into a contract if the parties so desire). The DCFR which is based on the PECL model, uses a slightly different wording which appears to further specify the requirement of ‘excessively onerous’ performance: Article 1:110 of Book III of the DCFR provides that the court may vary or terminate the obligation when the performance ‘becomes so onerous because of an exceptional change of circumstances that it would be manifestly unjust to hold the debtor to the obligation’\textsuperscript{17}. In this way, the DCFR includes two additional tests that are not present in other legal instruments, namely (i) the requirement of an ‘exceptional’ change of circumstances and (ii) that of ‘manifestly unjust’ performance\textsuperscript{18}.

Despite the above-mentioned differences between the UNIDROIT Principles, PECL and DCFR, these instruments share at least two general features: (a) they have all adopted an objective approach to hardship\textsuperscript{19} as opposed to merely subjective considerations such as those known in German, US\textsuperscript{20}.

\begin{enumerate}
\item Some authors note that the interpretation of the expression ‘manifestly unjust’ may be problematic because the assessment of justice may lead the court to examine factors which are external to the contract itself and entail high litigation costs, please see Uribe, R. M. The Effect of a Change of Circumstances on the Binding Force of Contracts: Comparative Perspectives. Cambridge: Intersentia, 2011, p. 202.
\item Both the German Störung der Geschäftsgrundlage doctrine (Paragraph 313 of the German Civil Code) and the US doctrine of impracticability (Article 2-615 of the Uniform Commercial Code, Articles 261 and 265 of the Second Restatement (Contracts)) are based on ‘material’ or ‘basic’ assumptions of the parties with respect to circumstances surrounding the performance of contract. These assumptions form the basis of the contract. If these assumptions later appear to be wrong (German law) or the performance becomes impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption (US law) then the party may be exempted from its contractual obligations.
\end{enumerate}
or Italian law\(^{21}\); (b) in order to successfully invoke the hardship (changed circumstances) exemption, the disadvantaged party must prove a disequilibrium of the contractual obligations\(^{22}\) which may manifest itself as an unreasonable increase of costs or decrease of the value of the performance. The latter may occur because of changes in the market or technology (for example, much more efficient technology is invented during the installation of the machinery) or frustration of the contractual purpose (for example, when the buyer intends to export the goods to a third country but such an export is prohibited by the law of the importing country, and the goods cannot be sold in any other market). Whether a disequilibrium may be considered as ‘fundamental’ or ‘excessively onerous’ will depend on the facts of each particular case. In view of the goal of legal security, the main criterion should be as objective as possible, ideally expressed in a percentage or other measurable figures. However, in some cases, a measurement in percentage is not appropriate, and therefore other standards should be employed. Both situations will now be further analysed.

2. Numeric Expression of the Hardship Alteration Threshold

2.1. General Overview

The exact determination of the required contractual equilibrium threshold (as expressed in a percentage or other numeric term) appears to be a particularly difficult endeavour in legal doctrine. Moreover, a distinction is necessary depending, among others, on the applicable legal system, the method of dispute resolution, the type of contract, the area of application (national or international contract), or the legal background of the judge/arbitrator. For example, in common law countries, no reliable standard has ever been established with regard to cost increase, and neither the published case law nor commentaries have proven helpful in this respect. For example, Prof. Treitel, when addressing the U.S. Restatement of contract law, Second provides an example of contractual impracticability where a ‘tenfold’ increase in cost to the seller has occurred, whereas English courts have mentioned that a ‘hundredfold’ increase could possibly cause a frustration of contract\(^{23}\). In international commercial arbitration cases, a cost increase by 13\%, 30\%, 44\% or 25-50\% was considered insufficient to qualify as

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21 Next to the doctrine of *eccessiva onerostà sopravvenuta*, which is based on objective criteria, Italian law also knows the wider doctrine of *Presupposizione*, which is based on subjective considerations, please see Yildirim, A. C., *supra* note 19, p. 61–65.

22 Even though the PECL and DCFR do not expressly mention ‘equilibrium’ in the provisions of these instruments (contrary to Article 6.2.2 of the UNIDROIT Principles), the commentaries of the PECL and DCFR provide that the change of circumstances must have brought ‘a major imbalance’ in the contract, see: Lando, O.; Beale, H., *supra* note 8, p. 324; *Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference, supra* note 9, p. 713.

hardship\textsuperscript{24}. No arbitral awards are known to the authors of this article where arbitrators would have granted relief merely because the costs of performance have increased by 50% or less compared to what had been agreed in the contract\textsuperscript{25}.

Quite a strict position has also been taken with respect to the financial crisis in different countries. For example, the economic crisis in Indonesia, which reached its peak in the years 1998-1999, resulted in a contraction of the Indonesian economy by approximately 15%, the loss of 5 million jobs, 80% loss of the value of the rupiah and an inflation rate exceeding 75%. However, this situation was held by both arbitral tribunals and commentators to be insufficiently extreme to qualify as hardship\textsuperscript{26}. Similarly, the economic crisis in Argentina in 2002 lead to a GDP decline of 10.9%, an inflation rate of 25.9% and a devaluation of Argentina’s peso which lost two thirds of its value against the US dollar. In this situation, an ICSID Arbitral Tribunal noted:

‘As stated above, the Tribunal is convinced that the Argentine crisis was severe but did not result in total economic and social collapse. When the Argentine crisis is compared to other contemporary crises affecting countries in different regions of the world it may be noted that such other crises have not led to the derogation of international contractual or treaty obligations. Renegotiation, adaptation and postponement have occurred but the essence of the international obligations has been kept intact.’\textsuperscript{27}

2.2 The UNIDROIT Principles Approach

It appears that the members of the drafting group of the UNIDROIT Principles were the first to address the issue on an international level. Thus, the commentary on the 1994 edition of the UNIDROIT Principles indicated as follows:

‘Since the general principle is that a change in circumstances does not affect the obligation to perform (see Art. 6.2.1), it follows that hardship may not be invoked unless the alteration of the equilibrium of the contract is fundamental. Whether an alteration is “fundamental” in a given case will of course depend upon the circumstances. If,

\begin{itemize}
\item \textsuperscript{27} CMS Gas Transmission Company v. The Argentine Republic, ICSID Case No. ARB/01/8, Award of 2005-12-05 [2005] [interactive]. [accessed 2012-02-07]. <http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC504_En&caseId=C4>, par. 355. This case was also reported by Brunnauer, please see Brunnauer, C., supra note 24, p. 441−445.
\end{itemize}
However, the performances are capable of precise measurement in monetary terms, an alteration amounting to 50% or more of the cost or the value of the performance is likely to amount to a “fundamental” alteration. 28

However, not all academics and practitioners agreed with the establishment of such a ‘50% or more’ rule. While some authors accepted or at least did not object to this rule 29, others recalled that there had been no awards where arbitrators had granted relief in cases of a mere 50% alteration 30; yet further authors stressed that at least for domestic contracts, a 50% rate appeared too low, especially with respect to countries with an unstable political and economic situation 31. Hence, it does not come as a surprise that the ‘50% or more’ rule was not included in the commentary on the 2004 edition of the UNIDROIT Principles. Rather, it was mentioned in the travaux préparatoires that this threshold was criticised in legal literature as ‘too low and in any event rather arbitrary’ 32. Consequently, the commentary on the 2004 edition provides a shorter description of hardship: ‘Whether an alteration is ‘fundamental’ in a given case will of course depend upon the circumstances.’ 33. This position remained unchanged in the 2010 edition of the UNIDROIT Principles 34. However, after repudiating the ‘50% or more’ rule, the official commentators of the UNIDROIT Principles did not offer any alternative to this rule. Rather, such an assessment was entrusted entirely to the judges or arbitrators. It is submitted that this position does not sufficiently promote legal certainty. Rather, the drafting group could have attempted to provide more precise guidance with respect to the alteration threshold 35. According to the commentary of the UNIDROIT Principles,

30 Houtte van, H., supra note 25 p. 190.
31 Doudko, A. G., supra note 19, p. 496.
34 Principles of International Commercial Contracts, supra note 7, p. 214.
35 There is only one specific example in the UNIDROIT Principles: ‘In September 1989 A, a dealer in electronic goods situated in the former German Democratic Republic, purchases stocks from B, situated in country X, also a former socialist country. The goods are to be delivered by B in December 1990. In November 1990, A informs B that the goods are no longer of any use to it, claiming that after the unification of the German
it is most likely that a cost/value alteration of less than 50% will not be considered as fundamental. However, this does not allow the conclusion that a cost/value alteration of more than 50% will be considered fundamental\textsuperscript{36}.

2.3. Further Considerations with Respect to Alteration Threshold

When analysing the legal doctrine dedicated to the hardship and fundamental alteration criterion, the position of the Swiss expert Christoph Brunner is of particular interest, because Prof. Brunner is the author of the most extensive and most recent treatise on \textit{force majeure} and hardship in English\textsuperscript{37}. He analysed cases of both common law and continental law courts and tribunals and suggested, depending on certain typical circumstances, an alteration threshold of between 80% and 100% (excluding any profit margin) or of 100-125% (including a typical profit margin)\textsuperscript{38}. In order to determine whether the threshold is reached, he suggests to compare the actually expected costs with the estimated objective costs after the occurrence of the supervening event. According to Brunner, the 80-100% limit should be heightened in case the debtor has assumed a greater risk of contract performance, or lowered in case the debtor has assumed a smaller risk\textsuperscript{39}. Risk assumption or non-assumption can be express (established in the contract or statutory provisions) or implied, taking into account all relevant circumstances. Concluding a speculative contract usually leads to a higher level of risk assumption. According to Prof. Brunner, a higher profit margin may indicate that the supplier assumed a greater risk with regard to contingencies\textsuperscript{40}. It is submitted that the method proposed by Brunner will face difficulties because business subjects rarely tend to disclose their profit margins, and in case of a dispute, such disclosure may become even more difficult. Further complications may be expected in those instances where a specific profit margin is not calculated nor even planned with respect to a particular contract or only on the basis of an entire business relationship between the same parties.

Moreover, even though the position of Prof. Brunner has been very well presented, it appears doubtful whether his suggested alteration threshold may serve the purpose of fixing a standard in international commercial practice, in particular when looking at the recent case law and doctrine. For example, Prof. Schwenzer, the editor of the best known commentary of the 1980 United Nations Convention on Contracts for the International Sale of Goods, notes that even a 100% cost increase is usually insufficient to exempt the party from contractual obligations under Article 79 of the 1980 Convention\textsuperscript{41}. Rather,
Prof. Schwenzer suggests setting a margin of 150-200% (with respect to international contracts). On the other end of the spectrum, in an ad hoc arbitration case reported by R. Fucci, the tribunal acting under the UNCITRAL Arbitration Rules considered a contract entered into by an Italian construction company in 1985 with the government of Kuwait for the construction of a new Kuwaiti embassy in Algeria. The currency of payment was U.S. dollars. Two of the three arbitrators accepted a depreciation in the value of the U.S. dollar with respect to the Italian lira of about 35% as a changed circumstance justifying compensation to the contractor when its costs were incurred largely in Italian lira. It must be noted that one arbitrator dissented, by stating that the depreciation was not extreme enough to allow adjustments. In another case, the Belgian Supreme Court, in 2009, confirmed hardship in case of a 70% steel price increase.

Considering these vast differences, we submit that it is not advisable to establish a universal and mathematically precise alteration threshold. Rather, regard should be given to the circumstances surrounding the contract, including but not limited to its duration and purpose, the level of risk assumption, as well as the experience, economic status and financial capabilities of the parties. Also, it should be examined whether and how the supervening events burdened the counter-performance, i.e. not only the debtor’s but also the creditor’s situation should be assessed. All these criteria are also important when determining the further requirements for the application of hardship, namely foreseeability, possibility to control the events, risk assumption, etc.

The legal exemption of hardship has developed as a counterbalance to the rigid rule of pacta sunt servanda. In some instances, a strict application of the pacta sunt servanda principle may conflict with the concepts of equitable justice, reasonableness, and good faith. Hardship rules add the necessary flexibility. This flexible attitude must also be retained with respect to the fundamental alteration threshold. However, a numeric standard may not be the only possible method to establish a relevant threshold. There may be further criteria which will now be addressed.

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Fucci, F. R., supra note 26, par. II.B.


Article 6.2.2 (points a, b, c, d) of the UNIDROIT Principles; Article 6:111(2) (points a, b, c) of the PECL; Article 1:110(3) (points a, b, c, d) of the Book III of the DCFR.
3. Alternative Criteria that May Determine Hardship Situation

As mentioned above, in some situations, the traditional numeric expression criterion is not the only or not at all appropriate to determine whether or not the hardship exemption should be allowed. This may be the case in situations, in which: i) the increase of costs or diminution of value cannot be measured in numeric terms (part 3.1 of this article); ii) the increase of costs or diminution of value can be measured in numeric terms but the required alteration threshold must be significantly lowered or heightened (in part 2.3 of this article we have already discussed that the threshold may be adjusted in accordance with the risk assumption level; in part 3.2 of this article we will discuss the application of a lower threshold due to an imminent financial ruin of the debtor); iii) the increase of costs or diminution of value is only indirect (parts 3.3 and 3.4 of this article); iv) in frustration of purpose situations, the required diminution of value should only be applied together with the frustration of joint purpose requirement (part 3.5 of this article).

Moreover, it should be noted that the above-mentioned list of fundamental alteration criteria (as an alternative or extension of the mere numeric expression) can only be indicative. Hardship is a flexible legal concept that may occur in different forms; and therefore, no list of contractual disequilibrium situations will be complete. However, we will address the following five particularly important situations hereunder: threat to people or property, financial ruin of the debtor, opportunity costs, windfall gains and frustration of purpose.

3.1. The Performance of the Contract Would Jeopardise Safety of People or Property

In order to introduce this additional (or alternative) criterion, a hypothetical example may be analysed, which is inspired by the 1974 US case *Northern Corp. v. Chugach Electric Assoc.*, reported by Prof. Perillo. A contractor who is engaged in the building of houses in Alaska’s wilderness needs to move a large quantity of stone from one side of a lake to another. The normal way is to move stones over a frozen lake by truck. Let us assume that this method is well known in Alaska and has been practiced for many years with no serious accidents reported. However, the ice cracked and the truck sank and

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47  *Northern Corp. v. Chugach Electric Assoc.*, 518 P.2d 76 (Alaska 1974). Reported in: Perillo, J. M. Hardship and its Impact on Contractual Obligations: a Comparative Analysis. In: Saggi, Conferenze e Seminari, 20, Roma: Centro di studi e ricerche di diritto comparato e straniero, 1996, p. 11. The original case plot, as reported by Prof. Perillo, is the following: ‘One of the steps in a construction subcontract in the Alaskan wilderness was to move a large quantity of stone from one side of a lake to the other. The anticipated mode of performance was to move the stones by truck over the lake when its surface froze. On the first attempt, the subcontractor lost a truck that fell through the ice into the water below. The driver, however, was saved. On the second attempt when the ice thickened further, the subcontractor lost 2 trucks and 2 drivers. It was not impossible to move those stones. The subcontract could have waited until the summertime, and then brought in a barge – a kind of boat that is used for river and lake transport – and then move the stones over the water. This would have involved a large unanticipated additional expense. The court held that that the contract was discharged and the contractor was justified in refusing to render further performance. Cases of this sort have been few, but the outcome of the case is generally regarded as sound’.
the driver drowned. An additional inspection of the ice by a non-governmental agency showed that the other routes over the lake would have been safe as the ice was very thick. Alternative transportation methods did not exist because the area was surrounded by mountains and there was no other way to reach the point of construction.

It must be noted that in cases such as this, it is questionable whether this situation amounts to impossibility or *force majeure* instead of mere hardship. Assuming that it does not, the question remains whether the contractor could be exempted on the basis of excessively onerous performance, i.e. hardship. As an alternative, the court or arbitral tribunal may adjust the contract, for example, by allowing the contractor to deliver stones in the summer by barge, without having to bear the full consequences of a delay of several months. Or it may declare the contract terminated and the contractor exempted from paying damages. Other cases may be added to this category. For example, in a case where the solo opera singer is advised by medical staff to skip a few concerts due to a minor breathing disorder, the singer could possibly insist on changing the concert tour schedule. In such cases, even though the singer may not obtain a medical certificate prohibiting her to sing, the mere medical recommendation may serve as an indication of a possible excessively onerous performance due to the increased risk of further damage to the singer’s health. It is thus submitted that in such cases, a fundamental alteration cannot merely be measured in numeric terms: in these cases, an excessively onerous performance (fundamental alteration of the contractual equilibrium) occurs not only due to increased costs in monetary terms (e.g. higher transportation costs) but rather due to the increased risk to people or property. Therefore, one must distinguish between increased cost of performance and a possible (further) damage to the creditor. While the damage may be measured in monetary terms, it may also be dealt with in the form of adjustment or termination of the contract due, thereby distributing the losses and risks between the parties.

### 3.2. Increased Risk of Financial Ruin of the Debtor

According to the general rule, the deterioration of a party’s financial capacity falls within the sphere of control of this party and thus does not authorise this party to invoke the hardship exemption. However, in some exceptional cases, especially when the debtor is a small company and loses a major part of its income due to changed circumstances, a more flexible approach towards alteration threshold may be justified.

The essential criterion in this situation is the fact that performing the contract in its unaltered form would result in a financial ruin and possible bankruptcy of the debtor. However, if an assessment of the whole contractual context suggests that the debtor’s financial ruin is due to a lack of managerial skills or resources, the debtor should not be entitled to lower the alteration threshold. Otherwise, parties without resources may be unjustly favoured. Also, it is very important to evaluate the debtor’s ability to absorb the losses in cases where the debtor’s company belongs to a group of companies. For

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49 Ibid., p. 437.
example, losses of a subsidiary may possibly be absorbed by the parent company. In these cases, it is important to assess the financial capacity of the parent company or the whole group of companies. Also, care must be taken in cases where the parties have concluded several contracts, and it should be noted that some contracts may be financially detrimental while others may be profitable. Therefore, in any event, the overall financial situation must be examined. For example, in a German case, the building companies, who committed to supply family homes with direct heating, could not escape the bargain when due to a price increase of coal the builders were losing nearly 60,000 DM per annum. The court reasoned that the enterprise was large enough to absorb such losses. A similar position was taken in arbitration proceedings in 2005 that involved the group ‘Petrobras’ which was controlled by the Brazilian government, El Paso Energy, MPX Energia, Enron and others. Beginning in 2000, there was a serious drought in some areas of Brazil and the supply of power was severely constrained. The Brazilian government put an emergency programme to install thermoelectric power plants. Contracts with foreign investors were concluded, and Petrobras agreed to cover the developers’ cost of capital, operating costs and taxes in case the plants’ sales revenues would not be sufficient. The power plants were built on schedule but since by that time, the consequences of the drought had eased, and due to the lack of energy demand, Petrobras had to cover the developers’ losses as agreed. By 2004, Petrobras announced that its power sector losses during the first nine months of 2004 amounted to Brazilian reais 962 million, and Petrobras attempted a renegotiation of the contracts. In one instance, the Central Court of Rio de Janeiro, upon a request for interim measures filed by Petrobras, rejected hardship arguments of Petrobras. The court noted inter alia that even though Petrobras suffered significant losses, it was a very profitable enterprise and could still make the payments to the investors. It is thus submitted that while in practice, financial difficulties of the debtor will not normally be considered a fundamental alteration of the contractual equilibrium, financial ruin remains as a possible ground which under certain circumstances may allow application of the hardship exemption.

3.3. Lost Opportunity Cases

In some cases a situation may arise where the debtor’s cost increase or performance value decrease is rather theoretical than actual. This is quite common in lease cases, where due to a booming real estate market the lease prices increase or, in the opposite situation, due to financial crises or other reasons, lease prices decrease. Stricto sensu, these situations could not be qualified as hardship because the lease price fixed in the contract remains the same and the same object is still available. Consequently, this situation

52 Reported by R. Fucci in Fucci, F. R., supra note 26, par. II.A, B, C, D.
53 Fucci, F. R., supra note 26, par. II.C.
does not literally meet the ‘fundamental alteration’ standard provided in the UNIDROIT Principles and other instruments. Prof. Brunner labels these situations as a loss of ‘opportunity costs’. In such cases the owner’s loss consists in the difference between the contractually agreed rent and the higher rent which it would obtain by renting the land/premises to a third party at current market conditions\(^{54}\). The increased opportunity costs could be qualified as a cost increase within the scope of the UNIDROIT Principles provided that the relevant alteration threshold is reached and other hardship conditions are present (changed circumstances occurred due to unforeseen event, the landlord did not assume the risk of such changed circumstances, etc.). Similarly, the tenant’s loss consists of the difference between the contractually agreed rent and the lower rent if it could rent the land/premises from a third party. This decrease in opportunity costs could be qualified as a diminution of value within the scope of the UNIDROIT Principles.

A recent decision of the Supreme Court of Lithuania may be mentioned in this context\(^{55}\). In 2002, the parties concluded a fixed-term commercial premises lease agreement that was supposed to end in 2019. In 2009, the tenant requested a court to amend the contract and restore the contractual balance by decreasing the rent payment from 50 litas per 1 m\(^2\) to 33 litas per 1 m\(^2\). The tenant explained that by the time the parties had concluded the contract, the tenant could not have foreseen the world financial crisis starting in 2008. Due to this crisis, the lease prices in the market decreased by 30%-40%, thus the contract needed to be adjusted. The courts of lower instance granted the tenant’s claim and amended the contract, and the Supreme Court of Lithuania confirmed the decisions of the lower courts. It did not invoke the theory of ‘opportunity costs’ but rather attributed this situation to a fundamental diminution of value which in the courts’ view amounted to hardship. It is submitted that the court’s decision to declare hardship in this situation must be criticised for the following reasons: (1) it is doubtful whether the numeric expression of the alteration of the contractual equilibrium (30%-40%) should be qualified as fundamental. As discussed above, only in exceptional cases may a threshold which is lower than 50% be justified, and it is submitted that no such exceptional situation existed in the Lithuanian case; (2) the alternative fundamental alteration criteria\(^{56}\) could not be applied here either because the debtor was not trying to prove the threat of the company’s financial ruin, and there was no threat to the debtor’s personnel or property. In conclusion, it is submitted that opportunity costs may only be considered an indirect expression of a fundamental alteration of the contractual equilibrium, but should nevertheless be acknowledged as a possible basis for the hardship exemption if all other conditions are met.

### 3.4. Windfall Gains

The situation of ‘windfall gains’ is very similar to that of lost ‘opportunity costs’, but may be discussed separately nevertheless. Situations exist in practice where the

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\(^{55}\) Ruling of the Supreme Court of Lithuania of 31 May 2001, civil case No. 3K-3-265/2011.

\(^{56}\) Also discussed in parts 3.1 – 3.5 of this article.
equilibrium of the contract is altered in such a way that one party’s situation does not change but the other party receives windfall profits. The classical example is a sale of a cow, of which both parties believed that it was infertile. However, it later turned out that the cow was bearing a calf. The cow’s value, in the light of this information, would have been approximately ten times the agreed contract price\(^{57}\). Another example is a painting sold for a relatively minor sum, but it later appeared that the sold painting was a rare masterpiece worth hundreds of thousands or more. It must be noted that many legal systems and legal instruments would qualify these situations as ones of fundamental error or mistake. For example, in PECL, DCFR and in the ‘Translex Principles’, rules on hardship are only applicable with respect to supervening events (occurring after the conclusion of the contract) while earlier events fall within the scope of mistake. However, Article 6.2.2 (a) of the UNIDROIT Principles uses the wording ‘the events occur or become known to the disadvantaged party after the conclusion of the contract’. This means that the rules on hardship established in the UNIDROIT Principles may apply to both antecedent and supervening events, where the latter events become known to the disadvantaged party only later. Returning to the above discussed examples: even though the cow’s calf and the real value of the painting existed already at the time of the conclusion of the contract, these situations (at least under UNIDROIT Principles) could possibly be considered as falling within the hardship exemption because the facts became known to the disadvantaged party only later. It is questionable whether such windfall gains should be considered as a fundamental alteration of the equilibrium of the contract. It is, however, submitted that such windfall gains may be qualified as opportunity costs (as discussed in part 3.3 of this article) and thus may well fall within the hardship exemption nevertheless.

One more example of windfall gains could be mining or oil extraction contracts, where the contractor, who has obtained the right to exploit natural resources, starts extracting much larger quantities and generating much higher profits than both parties anticipated during the conclusion of the contract. The application of the hardship exemption to such cases is problematic. As duly noted by Prof. Horn: ‘Strictly speaking, envy is no hardship for the less lucky party’\(^{58}\). However, many authors, including Prof. Horn, do not agree with any opportunistic behaviour of one of the parties\(^{59}\). It is difficult to imagine a successful cooperation between the parties (especially in the long term perspective) where one party obtains totally unexpected profits on a regular basis, except where such gains come as a quid pro quo for the exceptionally high risk assumed.

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by that party. Therefore, it is submitted that in cases of highly unexpected windfall gains, especially in long term contracts, the parties should be encouraged to look for a compromise, i.e. to attempt renegotiations of the contract, thereby possibly restoring the contractual balance foreseen by the parties at the moment of the conclusion of contract. If such cases are addressed by the courts, windfall gains may possibly be classified as opportunity costs and thus acknowledged under the hardship exemption (if they are not attributed to the category of mistake). Again, whether or not such a classification is appropriate, may depend on further circumstances such as contract type, duration of the contract, etc.

3.5. Frustration of Purpose

The legal doctrine of frustration of purpose was developed in English case law. When applying this doctrine, the most important test is to determine whether the frustrated purpose was the common purpose of both parties. For example, if the buyer of the goods or the recipient of the services did not share its purpose with the seller/service provider then the use of goods or services falls entirely within the sphere of risk of the buyer/service recipient. However, the sole fact that the seller knew about the intended use of goods/services does not mean that such use constituted the ‘common purpose’ of the parties within the ambit of the doctrine. Rather, it must be proven that the common purpose was the main incentive for the parties to conclude the contract. It must be noted in this context that the mere goal of obtaining profit is usually not considered the common purpose of the contract.

In modern contract law instruments, frustration of purpose falls within the scope of diminution of the value of the contractual performance. It is submitted that in such cases, the value of the performance should diminish by 80-100% to reach the hardship threshold, i.e. the performance must become totally or almost totally useless for the creditor. In particular, it should be thoroughly examined whether the party relying on the doctrine of hardship may have been able to use the goods or services for other purposes or employ other methods than originally intended and thereby avoid the frustration. For example, in the U.S. case *Amtorg Trading Corp. v. Miehle Printing Press & Manufacturing Co.* the U.S. producers sold printing presses for exportation to Russia. After the conclusion of the contract the U.S. passed trade sanctions against the USSR and the printing presses could not be exported to Russia. A U.S. court ruled that even though the purpose of the contract (export to the USSR) was known to both parties, this was not sufficient to apply the doctrine of frustration of purpose because the buyer had a chance to export the goods to other countries or to sell them in the U.S. domestic market.

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In another case, Congimex, etc. SARL v. Tradax Export SA, the Portuguese seller intended to import soya beans into Portugal but the Portuguese government applied import restrictions and refused to issue an import licence. The court rejected the buyer’s claims for frustration of purpose as it was inter alia determined that the seller duly performed his duties whereas the buyer had a chance to divert the goods to a third country, e.g. France. Another relevant example derives from the alcohol prohibition in the U.S. in the 1920s. As noted by Prof. Treitel, there seems to be no reported case in which a contract for the supply of hops to a brewer was held to have been frustrated. It was suggested that the buyers could have resold the goods, at least for export.

It goes without saying that these examples may not provide for specific or strict standards. In every case, all surrounding circumstances must be examined. For example, if a family orders a travel package for skiing holidays but it appears that due to a warm winter there is a lack of snow and all the slopes are closed, foreseeability and risk assumption criteria must come into play, the provisions of the contract must be thoroughly examined as well as any warnings of the travel agency, any possibilities to relocate the skiers to another skiing resort, etc. Only a meticulous examination of the surrounding circumstances would thus ensure a just and well-reasoned decision.

In the light of the above, it may be concluded that frustration of purpose cases may clearly fall within the category of hardship exemption. However, in order to declare frustration of purpose cases as ones of hardship, it must be necessarily determined whether the common contractual purpose of the parties has been frustrated.

Conclusions

Fundamental alteration of the equilibrium of the contract, even though not literally established in all legal systems, is the main criterion under the hardship exemption. In other words, hardship may occur where an essential increase of costs or diminution of the performance value is the effect of a situation for which a party invokes the hardship exemption.

A numeric expression of the contractual equilibrium alteration is a regular and useful tool to determine a hardship situation, but there can be no universal alteration threshold which would serve as a general standard for all cases. However, international practice shows that only in exceptional circumstances may an alteration of less than 50% of the contractual price, value or consideration be qualified as hardship.

In some cases, a numeric expression criterion may not be applicable at all as a fundamental alteration test.

66 Treitel, G. H., supra note 23, p. 333.
Financial incapacity of the debtor usually does not exempt the debtor from performance. However, if changed circumstances resulted in a financial ruin of the debtor, the hardship alteration threshold might be adjusted, depending on the specific circumstances of the case.

The loss of opportunity costs may, if considered fundamental, fall within the category of increased costs or diminished value of the performance. The contract may thus be adjusted or terminated provided that all other hardship conditions are fulfilled.

Frustration of purpose cases should focus upon the determination of the common purpose of the parties. The diminution of the value in these cases must be total or almost total.

References


Yildirim, A. C. Equilibrium in International Commercial Contracts: With Particular Regard to Gross Disparity and Hardship
Santrauka. Daugelis valstybių savo įstatymuose įtvirtino specialias nuostatas, skirtas pasikeitusių aplinkybių (sutarties vykdymo suvaržymo) doktrinai, o kai kurios valstybės šią doktriną pripažįsta teismų praktikoje. Ši doktrina buvo įtvirtinta ir pagrindiniuose nepri
valomojno pobūdžio sutarties teisės instrumentuose (UNIDROIT tarptautinių komercinių su
tarčių princupose ir kt.). Pagrindinė sutarties vykdymo suvaržymo doktrinos taikymo sąlyga yra esminis sutartinių prievolių pasikeitimas, kuris gali pasireikšti kaip esmi
nis sutarties įvykdymo suvaržymo sąnaudy padidėjimas arba esminis įvykdymo vertės sumažėjimas. Šio straipsnio tikslas yra atskleisti esminio sutartinių prievolių pasikeitimo turinį ir bruožus. Pagrindinis tokio pasikeitimo kriterijus yra sutartinių prievolių pasiausvyros bu
kreipimo skaitinė įsakymo, tačiau identifikavimas, koks konkrečiai pasikeitimas (matematine prasme) yra pakankamas pripažinti šalies teisė į sutarties adaptaciją / nutraukimą yra viena sudėtingiausių problemų sutarties vykdymo suvaržymo instituto kontekste. Tarptautiniame komerciniame arbitraže mažesnis nei 50 % sąnaudų išaugimas paprastai nesuteikdavo šalies teisė į sutarties vykdymo suvaržymą. Straipsnyje pateiktiemė nu
monė, kad matematiškai tiksli pasikeitusių aplinkybių standartas neturėtų būti įtvirtintas. Kiekvieniu individuiniu atveju turi būti vertinamas visas sutarties kontekstas ir reikšmingos aplinkybės, tokios kaip sutarties rūšis, trukmė, rizikos prisiėmimo laipsnis, šalių patirtis ir finansinė galimybės ir t. t.

Straipsnyje taip pat nurodoma, kad tam tikrais atvejais sutartinių prievolių pasikeitimu
mas negali būti išreikštas skaitine įsakymo, arba pasikeitimo standartas turi būti reikšmingai sumažintas arba padidintas. Tokių atvejų sąrašas bet kokiu atveju nėra baigtinis, nes sutar
ties vykdymo suvaržymo doktrina privalo išsikišti lankstai ir pritaikoma įvairiore situacijose. Šios situacijos, alternatyvios tradicinių skaitinei įsakymai, susiklosto tuomet, kai sutarties vyk
dymo suvaržymas pasireiškia padidėjusia rizika žmonių arba turto saugumui; kai sutarties pažodinės įvykdymas jų išlaidas ir jiems neįvykdymo vertė „sumažėja“ netiesiogiai („galimybių kašto“ teorija); kai sutartinių prievolių
pusiausvyra iškreipiama tokiu būdu, jog vienos šalies padėtis iš esmės nepasikeičia, o kita šalis gauna neplanuotai didelį pelną; kai sutarties įvykdymas vienai iš šalių tampa beprasmis, t. y. žlunga sutarties tikslas ir t. t. Sutartinių prievołių pusiausvyros pasikeitimo atvejai straipsnyje nagrinėjami sisteminiu ir lyginamoju metodu.

Reikšminiai žodžiai: sutarties vykdymo suvaržymas, pasikeitusios aplinkybės, esminis pasikeitimas, pasikeitimo lygmuo, sutartinių prievołių pusiausvyra.


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