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Content:

CHANGED CIRCUMSTANCES AND PACTA SUNT SERVANDA

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To what extent can arbitrators grant relief when the context which prevailed when the contract was concluded has substantially and unforeseeably changed so that contract performance has become more onerous? This question is obviously to be answered according to the national law chosen by the parties or the arbitrators, if they elect to do so. This contribution will attempt to determine the rules which would be applicable if the parties or the arbitrators, in the absence of a choice of law by the parties, have resorted to transnational rules.

The sanctity of contract is one of the most fundamental principles of law (I). However, the interaction between the sanctity of contract and changed circumstances has to be investigated. This paper will therefore focus on the hardship clauses which provide for a change in circumstances (II). It will then briefly consider to what extent arbitrators - amiable compositeurs - may grant relief because of changed circumstances (III). It thereafter will examine whether arbitrators who are not amiable compositeurs and who cannot apply an hardship clause, are entitled to grant relief because of changed circumstances (IV). Finally, the remedies available in a case of changed circumstances will be analysed (V).

I. THE SANCTITY OF CONTRACT

By nature the future is uncertain. In long-term contracts, prices may suddenly increase, inflation may rise, performance may become; more onerous. However, parties are expected to foresee. They can plan the future through contracts, especially through long-term contracts. In these contracts, they can fix the price and define the performance once and for all. A sales contract, for instance, guarantees the buyer that the purchased goods will be at his disposal at a given date (or at least that he will obtain compensation if the supplier fails to deliver them at that date); it guarantees the supplier...
payment of the specified amount at the agreed date. Contracts are thus "un îlot de sécurité face aux réalités mouvantes de l'avenir". A contract will only guarantee performances when it does not yield to the pressure of unforeseen developments.

The sanctity of contract is, understandably, a paramount feature of the law of contract. **Pacta sunt servanda**: the contract has to be respected. As a matter of principle, parties must adhere to the terms of their contract. This explains, for instance, why economic hardship does not affect international sales under the Vienna Convention on International Sales.

Arbitrators have to apply the terms of the contract which parties have agreed upon. Arbitration treaty law, arbitration statutes, as well as arbitration rules confirm that the arbitrator has to respect the contract terms. Arbitrators have frequently confirmed the sanctity of contract.

For disputes with a state or state entity as a party, arbitrators often rely an pacta sunt servanda. This may not surprise as contracts concluded with such parties are generally submitted to rules of international law, which includes the principle of pacta sunt servanda. In the Sapphire v. National Iranian Oil Company award, for instance, the arbitrators expressly stated: "It is a fundamental principle of law, which is constantly being proclaimed by international courts, that contractual undertakings must be respected. The rule pacta sunt servanda is the basis of every contractual relationship."

In the Liamco v. Libya award, the arbitrator also relied on pacta sunt servanda, emphasising "that a freely and validly concluded contract is binding upon the parties in their mutual relationship".

Arbitrators often have recognized the sanctity of contract by reference to a specific national law. Pacta sunt servanda is indeed also a paramount principle in all municipal legal systems. As one arbitrator held:

The principle of the sanctity of contracts ... has always constituted an integral Part of most legal systems. These include those systems that are based an Roman law, the Napoleonic Code (e.g. article 1134) and other European civil codes, as well as Anglo-Saxon Common Law and Islamic Jurisprudence 'Shari'a'.

Moreover, Pacta sunt servanda is considered a cornerstone of the lex mercatoria. Indeed, in some instances arbitrators have applied pacta sunt servanda as a transnational principle of private law. In ICC Award No. 5485 (1987), the arbitrators stated:

Whereas the rule pacta sunt servanda implies that the contract is the law of the parties, agreed to by them for the regulation of their legal relationship, and generates not only the obligation of each party to a contract to fulfill its promises, but also the obligation to perform them in good faith, to compensate for the damage caused to the other party by their non-fulfillment and to not terminate the contract unilaterally except as provided for in the contract ...

More frequently, however, arbitral awards simply apply the contract terms to the dispute and thus impliedly recognize the binding force of the contract.

**II. CONTRACTUAL PROVISIONS ON CHANGED CIRCUMSTANCES**

Parties, who are aware that the context of the contract may change, can agree on a hardship clause in their contract. Some of these clauses provide the contract will terminate when a specified change in circumstances has occurred. Other clauses, such as indexation clauses or price revision clauses provide the contract terms will be automatically changed if such circumstances arise. Finally, some clauses, adaptation clauses, merely order the parties to adapt the contract terms to the new circumstances.

Some authors have argued that the widespread use of hardship clauses in long-term contracts has created a custom: the hardship clause must be implied in the contract even if it was not expressly included by parties. However, the fact that parties sometimes include a hardship clause in the contract may prove that no general customary principle exists.
Moreover, there is such a variety in these hardship clauses with regard to their scope, application and remedy, that it is difficult to base a customary principle on them. In fact, arbitrators have consistently refused to read customary hardship clauses into long-term contracts. Rather, they have ruled that hardship clauses should be interpreted strictly. Accordingly, a clause mentioning specific changes must be interpreted as meaning that no other changes should be taken into account. For example, a hardship clause on currency exchange rates did not allow price increases when the commodity price, rather than the exchange rates, increased. Similarly, a clause which allowed the renegotiation of the purchase price every 6 months excluded interim adaptations because of changed circumstances.

However, the mere presence of a hardship clause should not in itself exclude the application of the general law on changed circumstances. It would be too cumbersome if parties were obliged to negotiate and draft hardship clauses covering all possible events which may affect performance. Consequently, the general law on changed circumstances remains applicable to all changes not covered by a hardship clause. This principle has been recognized by arbitrators from the Arbitration Court of the Japan Shipping Exchange, who stated:

The relation between this Article (renegotiation clause) and the principle of change in situation is such that the present article does not exclude the said principle, but provides for either one of the parties to request the other for consultation to amend the price, even in the instances where the principle of the change in situation does not need to be applied.

Parties may specifically instruct the arbitrators to take account of the changed circumstances after the dispute has arisen. When the Iran-US Claims Tribunal was set up, the arbitrators were ordered "to decide all cases an the basis of respect for law, ... taking into account relevant usages of the trade, contract provisions and changed circumstances". The Iran-US Claims Tribunal thus considered it had a duty to take into account changed circumstances.

### III. ARBITRATION IN EQUITY AND CHANGED CIRCUMSTANCES

Arbitrators may be vested with the powers of amiables compositeurs, i.e., they have to decide ex aequo et bono. Amiable composition can depart from the strict provisions of the contract on the grounds of equity. Thus arbitrators can grant relief whenever they feel it fair to restore the balance between both parties' obligations, which has been disturbed by a change in circumstances. For instance, the arbitrators in the famous S.E.E.E.-Yugoslavia arbitration, who acted as amiables compositeurs, could grant relief because of the depreciation of the Yugoslav dinar.

### IV. REBUS SIC STANTIBUS AS RULE OF LAW

In general, national legal systems contain a rule that changed circumstances may affect the binding force of a contract. This possibility is known under the maxim rebus sic stantibus: the contract remains binding "provided that things remain as they are".

To limit the scope of the analysis, rebus sic stantibus will be interpreted restrictively. Express contractual conditions which have not been satisfied are excluded: such changes relate to the failure to satisfy the contractual condition for performance. The advent of an Act of God-Force Majeure, which makes performance totally impossible, is excluded. This paper will only focus on changes which make performance more onerous. Moreover, it does not encompass the hypothesis where a party discovers after the conclusion of the contract that the assumptions on which it concluded the contract were false. In such case, the factual circumstances have not changed; it was only their discovery which was delayed.

The principle of rebus sic stantibus, present in many national legal systems, is also a principle of international law. As the judges in the Iran-US Claims Tribunal recognized:

The concept of changed circumstances, also referred to as rebus sic stantibus, has in its basic form been incorporated into so many legal systems that it may be regarded as a general principle of law; it has also found a widely recognized expression in Article 62 of the Vienna Convention an the Law of Treaties.
A. INTERNATIONAL LAW

Rebus sic stantibus is a principle of international treaty law. The 1969 Vienna Convention on the Law of Treaties, Article 62, states:

A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of the obligations still to be performed under the treaty.

The wording of Article 62 demonstrates the exceptional character of rebus sic stantibus. It is subordinate to the more general principle of pacta sunt servanda, as set out in Article 26 of the Vienna Convention.

The change in circumstance has to be fundamental. It has to jeopardize the survival of the State. Simple loss of economic gain or currency reforms are insufficient. As the International Court stated in the Fisheries Jurisdiction case, the changes must be vital: they have to "imperil the existence or vital development of one the parties". Moreover, the change in circumstances has to be unforeseeable.

In fact, although parties have often invoked rebus sic stantibus before international tribunals, such parties have never been granted relief on these grounds. The International Court of Justice or other tribunals have always refused to apply rebus sic stantibus to a treaty.

B. NATIONAL LAW

In English law, the doctrine of "frustration of purpose" excuses performance when the circumstances have changed so much that the performance required by the contract is radically different from that which was initially undertaken by the parties. However, more recently, English judges have been generally reluctant to find that a particular contract has been frustrated.

In German law, the theory of Wegfall der Geschäftsgrundlage (disappearance of the Basis of the transaction) covers the effect of changed circumstances on the contract. Paragraph 242 of the German Civil Code (BGB) requires that the contract be performed in good faith. However, when the circumstances have unforeseeably and substantially changed, the foundations of the transaction have been destroyed and the parties are no longer bound to their original contractual commitments. Requesting the original performance of the contract would constitute bad faith. The Wegfall der Geschäftsgrundlage was quite easily applied in the years of galoping inflation after both World Wars. However, it has been less easily accepted with regard to commercial contracts concluded between businessmen. At present Wegfall der Geschäftsgrundlage is applied rather restrictively.

The Swiss Federal Tribunal has admitted that some long-term contracts may be terminated because of an unforeseeable and fundamental change of circumstances on the basis of Article 2 of the Code civil (good faith). Only changes which would unjustly enrich one of the parties give rise to such relief. Rebus sic stantibus, however, has to be applied restrictively.

The change in circumstances has to be substantial, striking and excessive; it should be apparent to any unbiased third party that the contractual performances are completely unbalanced. Moreover it is not sufficient that the contract performance should lead to the ruination of the seller in question - since his subjective situation cannot affect contractual obligations; only factors which would objectively affect any seller are relevant. Furthermore, the buyer should intend to exploit the inequity between his payment and the seller's performance. Finally, the seller has to be in distress or unfamiliar with the type of transaction. In a Swiss arbitral award, the Swiss law on rebus sic stantibus has been summarized as follows:

According to these (Federal Court) judgments, conditions for the clausula rebus sic stantibus in Swiss law are:

- the risk of changed circumstances should not have been distributed among the parties in the contract; if so, such a
provision would prevail;

**Referring Principles:**
- IV.1.2 - Sanctity of contracts
- VIII.1 - Definition
- V.2.3 - Nominal-value principle