The Underpinnings of Contractual Relations- when can a promise be broken?

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> "*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*."
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> -*Sapphire v. National Iranian Oil Company*, Arbitral award March 15, 1963, *I.L.R.*, 1967, 136 at 181.[1]

Introduction

The concept of sanctity of contract is based on the 19th century classical contract theory which is founded in the Aristotelian virtue of promise keeping, and liberality. According to the theory, a contract is an expression of the parties' free will or choice. It is an exercise of the parties' freedom and autonomy, as such, it should be honoured and not be interfered with by the court. The terms of the contract must be implemented to the letter no matter how onerous or burdensome they may prove to be. The individual is the best judge of his own interest and if he strikes a bad deal then he should blame himself and bear the risk. It is neither the duty of the court nor that of the state to inquire into the fairness or otherwise of the contract; their role is to enforce what the parties have agreed to do. After all, enforcing contracts enhances economic efficiency.[2]

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[1] Changed Circumstances and Pacta Sunt Servanda, Hans van Houtte, http://tldb.uni-koeln.de/php/pub_show_document.php?pubdocid=117300.

[2] Renegotiation and Contract Adaptation in the International Investment Projects: Applicable Legal Principles & Industry Practices, Abba Kolo and Thomas Walde, Oil, Gas & Energy Law Intelligence, Vol. I, Issue #02-March 2003, http://www.gasandoil.com.

As the process of contract negotiation, drafting and execution has moral, practical and legal considerations, it is no surprise then that the doctrine of p*acta sunt servanda* came into being. *Pacta sunt servanda* is a concept in international law which literally means – the contract has to be respected. It reflects natural justice and economic requirements because it binds a person to its promises and protects the interests of the promisee. Since effective economic activity is not possible without reliable promises, the importance of this principle has to be underlined.[3].

On a pragmatic level, parties must adhere to the principle of sanctity of contract if only to ensure that they do not renege on their promises upon a whim, that they cannot vacillate from doing and not doing, thereby making contract adherence certain. On this premise, it may be said that the law on contracts may be deemed inutile without the assurance that parties will perform that which was contractually expected of them.

The age old doctrine of sanctity of contracts may perhaps be considered as having evolved in light of the various commercial transactions that men enter into across borders and over time. It would appear easy enough to fully submit oneself to a contract where the object or purpose is accomplished immediately upon the execution thereof or within a reasonable period of time thereafter. But in cases where parties contemplate complex transactions and a longer time frame before the contract's purpose is accomplished, perhaps adherence to the letter of the agreement may be rendered impossible or more onerous by circumstances arising after such contract is executed and said circumstances were not reasonably or could not have been reasonably foreseen by the parties.

In this jurisdiction, there have been instances where the Philippine Supreme Court allowed relief to a suitor on ground of changed circumstances where performance of the contract has become more onerous, impossible or illegal.

Under principles of international law, *lex mercatoria* and transnational law, changed circumstances had been recognized as well, albeit in most cases under stricter rules of interpretation, as a ground for

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[3] Dietrich Maskow in "Hardship and Force Majeure": 40 American Journal of Comparative Law (1992); p. 658; available at: <http://tldb.uni-koeln.de/TLDB.html>; TLDB Document ID: 126400.

re-negotiating, terminating or altogether withdrawing from contractual obligations. Under the law of treaties, the issue of changed circumstances had been rather settled. The Vienna Convention on the Law of Treaties of 1969 recognises two cases where performance can be excused because of unforeseen events. These are found under articles 61 and 62, thereof.

This paper is an attempt, albeit limited in scope, to give an overview of the effects of changed circumstances in contract performance in Philippine soil vis-à-vis- international realities in commercial transactions, where the parties raise at issue events that would render performance more onerous or impossible. This is not in any way intended to be the final word on Philippine jurisprudence insofar as the principle of change circumstances is to be applied to commercial (international) contracts. However, this paper is the writer's modest effort to give a glimpse to those who might be minded to know how Philippine law and jurisprudence, in comparison to international realities, tend to flow when confronted with the enigmatic query of- when can a promise be broken?

A comparative slant: common law and civil law

First of all, it seems that despite the differences, the following general characteristics (of a change circumstance defense) can be traced in all national jurisdictions: (a) occurrence of an event after the making of contract; (b) exceptionality and unforeseeability of the event; (c) alteration of the contract in an intolerable degree; and (d) no fault on the obligor's part. Nevertheless, the existing antitheses, at least between the civil and the common law regimes, should also be noted. xxx these differences are rooted in a dissimilar socio-political and jurisprudential background: namely, that common law views the contract as an instrument of liberalism and private autonomy, whereas civil law has ascribed a social function to private agreements, which are thereby affected by extra-contractual considerations. This fundamental difference finds its expression in the unwillingness of the common law to recognize frustration (or change circumstances) on the other hand and the rejection of adjustment as a general form of relief on the other.

It is well enough to recall that common law started from a point opposite to that of the civil law regimes -- namely, from an unaccepted liability rule -- and it turned out to reach a contrary doctrine: impossibility or frustration is always an excuse, unless the obligor undertook the risk of

the contingency. With respect to the manner of relief, a considerable liberalization has also taken place.[4]

On the other hand, Civil law is in principle more open to renegotiability of long-term contracts than common law in the English tradition and shape. Civil law was influenced by Roman law and medieval Canon law which included the maxim of "*rebus sic stantibus*" meaning that contracts were valid as long as the underlying circumstances which were essential in the conclusion of the agreement continued to exist. No civil law system will, therefore, provide an easy exit out of contractual obligations. Nevertheless, there are principles and a series of court cases available which allow lawyers to argue for the renegotiability of long-term contracts and judges/arbitrators to accept an escape from contractual obligations. The question of adaptation/escape has been applied in two cases: The German "*Wegfall der Geschaeftsgrundlage*" (under Art. 242 of the German Civil Code) and the French doctrine of "*imprevision*" especially in the case of the "*contrat administratif*" (administrative contract/concession contract).[5]

Nevertheless, even within a common set of rules and concepts, the habits of mind of lawyers in different legal systems, no doubt reinforced by rules of civil procedure, are too deeply ingrained to achieve practical uniformity in approach. The instinct of civil lawyers is to turn to rules contained in the code, whereas English lawyers turn principally to the terms of the contract. The difference between legal systems about what constitutes a good argument, what has intellectual strength and integrity, will prove hard to abolish.[6]

On this point, the Philippines has its roots in civil law principles. Although, it may also be said that the Philippine legal system is a peculiar

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[4] Frustration of Contract in International Trade Law and Comparative Law, Michael G. Rapsomanikas, Pace Law School Institute of International Commercial Law, Reproduced with permission of 18 Duquesne Law Review (1979-1980) 551-605, http://cisgw3.law.pace.edu/cisg/biblio/rapsomanikas.html.

[5] Supra, note 2.

[6] See, Hugh Collins, European Private Law and Cultural Identity of States in European Review of Private Law 3 (1995) pp. 353 at 356, 357-58, citation used by Christian Joerges, The Process of European Integration and the 'Denationalization' of Private Law in Børge Dahl & Ruth Nielsen (ed.), (1996) pp. 73-90, p. 82, cited in The Autonomous Contract- Reflecting the borderless electronic-commercial environment in contracting, Ralph Amissah, http://www.cisg.law.pace.edu.

hybrid mix of civil and common law principles, tracing its roots from our Spanish and American influences. This is reflected in the amalgam of our Codes that tend to have lifted sporadic provisions from both civil and common law principles.

Frustration is akin to the doctrine of "unforeseen events" (*théorie de l'imprévision*), which is known in civil law countries like the Philippines. This shall be discussed at length in another chapter of this paper.

Understanding change circumstances and *pacta sunt servanda*

The term "change of circumstances" is used here to refer collectively to a host of different concepts, applied nationally and internationally, that deal with changes in the economic, legal and business realities underlying a contractual agreement.[7]

The long-term nature of some contracts make them vulnerable to disruption from unforeseen events or events which the parties - for whatever reason - did not and perhaps could not deal with in the contract with sufficient time and in sufficient detail. The longer-term an agreement and the more exposed to geological, commercial and political risk, the more it becomes vulnerable to external events. Such events can make the operation of the contract partially impracticable or, from a commercial and financial perspective, no longer viable for one party. One consequence is for the parties to terminate the agreement or one party to withdraw. However, such complete destruction of the contract would then also destroy the contractual relationship which often would have continuing benefits for both parties. Parties can also suspend operations under the contract which if the issues are not solved will in many cases equally result in the destruction of the contract.[8]

Pacta sunt servanda is at the core of any contractual relations. It is always hoped that a party enters into a contract with the good faith

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[7] Changed Contract Circumstances, 2nd Edition: Case Annotated update (April 2005), Chengwei Liu, http://cisgw3.law.pace.edu/cisg/biblio/liu5.html.

[8] Supra, note 5.

intention of fulfilling his undertakings. No one goes into a contract saying to himself- "Well, I may or may not do as I promised, depending on how I feel today". For if everyone had that mindset then contractual relations would have perished along with the Roman Empire, and economic activity would not be as robust as it is, if at all economic activity would be possible. It would be absolute laissez-faire without boundaries.

Nonetheless, while contract performance is the rule, it is important to note that the principle of change circumstances may be a refuge where problems arise in the course of performance, where the change is such an extent that had the parties, acting as reasonable individuals, known them at the time of laying down the terms and conditions of the executed agreement, the parties would have not given consent.

Natural law, it is argued, does not uphold harshness and unfairness and, therefore, would not prejudice a party by obliging him to fulfill a commitment which is no longer apparent. This duty is one founded in law whether or not it is provided for by the expressed or presumed wills of the parties or positive law. Thus, it is admitted that, although the will creates the agreement, it is not the sole criterion for determining its limits and consequences. Laws and regulations also have a role in delimiting contractual undertakings.[9]

Rebus sic stantibus as an exception to the pacta sunt servanda rule

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 on the Law of Treaties.[10]

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[9] Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-Term International Commercial Transactions, this document is included in the TLDB by kind permission of Kluwer Law International, http://tldb.uni-koeln.de/php/pub_show_document.php?pubdocid=105700.

[10] See the Questech decision, 9 Iran-US C.T.R., 122-123: "[T]he consideration of changed circumstances in the present context is warranted by the express wording of Article V of the Claims Settlement Declaration. That Provision not only lays down the law to be applied by the Tribunal, but it also mandates the Tribunal to take into account relevant usages of the trade, contract provisions and changed circumstances when

Although it is applicable only to treaties governing sovereign States, VCLT has been noted to contain an article (Art. 61) dealing with impossibility of performance, and an article (Art. 62) defining "fundamental change of circumstances" in terms of *rebus sic stantibus*. In particular, the latter (Art. 62) has been deemed as "a strong argument for the existence of a general legal principle which might also be relevant to transnational contracts with or between private parties.[11]

The 1969 Vienna Convention on the Law of Treaties, Article 62, states that:

> 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.[12]

The wording of Article 62 demonstrates however that as a general rule, even a fundamental change in circumstances will not by and of itself allow for the termination of or withdrawal from the binding effect of a contractual relation. The change must be so fundamental as to have affected the very consent that the parties gave at the time when the circumstances had not yet been so changed. It is as if as the contract now

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deciding "all cases", thereby mentioning "changed circumstances" on the same level as "contract provisions". In the context of the Algiers declarations the inclusion of the term "changed circumstances" means that changes which are inherent Parts and consequences of the Iranian Revolution must be taken into account, cited in Changed Circumstances and Pacta Sunt Servanda, Hans van Houtte, http://tldb.uni-koeln.de/php/pub_show_document.php?pubdocid=117300.

[11] See Norbert Horn in "Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law": Horn ed., Adaptation and Renegotiation of Contracts in International Trade and Finance, Antwerp, Boston, London, Frankfurt a.M. (1985); p. 25; available at: <http://tldb.uni-koeln.de/TLDB.html; TLDB Document ID: 113700, cited in Changed Contract Circumstances, 2nd Edition: Case Annotated update (April 2005), Chengwei Liu, http://cisgw3.law.pace.edu/cisg/biblio/liu5.html.

[12] Vienna Convention on the Law of treaties, http://untreaty.un.org/ilc/texts/instruemts/english/conventions.

stands, with the change in circumstances, there was no meeting of the minds between the parties.

As still another I.C.C. arbitrator stated, *rebus sic stantibus* has to be interpreted very strictly:

> The principle *rebus sic stantibus* is universally considered as being of strict and narrow interpretation, as a dangerous exception to the principle of sanctity of contracts. Whatever opinion or interpretation lawyers of different countries may have about the "concept" of changed circumstances as an excuse for non-performance, they will doubtless agree on the necessity to limit the application of the so-called doctrine "*rebus sic stantibus*" (sometimes referred to as "frustration", "force majeure", "imprévision", and the like) to cases where compelling reasons justify it, having regard not only to the fundamental character of the changes, but also to the particular type of the contract involved, to the requirements of fairness and equity and to all circumstances of the case[13].

The natural law jurists, in connection with their theory of the contract as a means of voluntary transfer of resources from one party to another, recognized three cases of discharge: physical impossibility, legal impossibility and excessive onerousness of performance. However, the prevailing medieval theory, adopted in the major eighteenth century codifications, is the aforementioned *clausula rebus sic stantibus*. The content of this theory, effectuating a subsequent condition of discharge, is that contracts are made upon the tacit assumption that an existing factual situation having an important bearing on the contract will remain basically stable during the life of the contract.[14]

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[13] ICC award in case no. 1512, Indian Company v. Pakistani Bank (1976) 1 Yb. Comm. Arb. 128, at 129; Ad hoc arbitration, Hungarian State Enterprise v. Yugoslav Crude Oil Pipeline (1984) 9 Yb. Comm. Arb. 69, at 70, as cited in Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-Term International Commercial Transactions, this document is included in the TLDB by kind permission of Kluwer Law International, http://tldb.uni-koeln.de/php/pub_show_document.php?pubdocid=105700.

[14] See A. Von Mehren & J. Gordley, The Civil Law System 1040-43 (2d ed. 1977); Mejers, La Force Obligatoire des, Contracts et Ses Modifications Dana les Droits Modernes, in Acts Du Congress International De Droit Prive' 99, 101 (1950); R.

Arguably, the doctrine of *rebus sic stantibus* is likewise a recognized principle in international law. In effect, this doctrine tempers the vise-like grip of concluded contracts, where performance for one party may be rendered more onerous or impossible.

Rules of the game in international trade- hardship clause vis-à-vis *pacta sunt servanda*

The right to conclude contracts is one of the primordial civil rights acknowledged since olden times. It was the essence of "*commercium*" or "*jus commercii*" of the Roman "*jus civile*" whose scope was enlarged and extended by "*jus gentium*". Then it was always and constantly considered as security for economic transactions, and was even extended to the field of international relations. This fundamental right is protected and characterized by two important propositions couched respectively in the expression that "the contract is the law of the parties", and in the Latin maxim that "*Pacta sunt servanda*" (pacts are to be observed). The first proposition means that the contracting parties are free to arrange their contractual relationship as they mutually intend. The second means that a freely and validly concluded contract is binding upon the parties in their mutual relationship."[15]

Still and all, there may be certain exceptional cases where an unforeseen change in circumstances, diametrically opposed or totally alien to that originally contemplated by the parties, may render the performance of the contractual obligations burdensome for one of them, that it appears to radically place such party at a disadvantage, almost to a point that the

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Schlesinger, Comparative Law, 506 (ad ed. 1970), cited in Frustration of Contract in International Trade Law and Comparative Law, Michael G. Rapsomanikas, Pace Law School Institute of International Commercial Law, Reproduced with permission of 18 Duquesne Law Review (1979-1980) 551-605.

[15] Liamco v. Libya (award of April 12, 1977): Arbitrator: Dr. Sobhi Mahmassani (sole arbitrator); Claimant: Libyan American Oil Company (LIAMCO) (USA), Respondent: Government of the Libyan Arab Republic; Published in: Revue de l'Arbitrage, 1980, pp. 132-191 (French translation of the award, original in English), with a commentary (in French) by Prof Brigitte Stern pp. 3-43, l.c., entitled 'Trois arbitrages, un mème problème, trois solutions', http://tldb.uni-koeln.de/php/pub_show_document.php?page=pub_show_document.php&pubdocid=261400&pubwithtoc=ja&pubwithmeta=ja&pubmarkid=969000.

original intention or purpose for which the contract was entered into no longer exists or at the very least the economic cause has collapsed. Under this scenario, what relief is available to the aggrieved party?

Parties, who are aware that the context of the contract may change, can agree on a hardship clause in their contract. 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 the parties. However, the fact that parties sometimes include a hardship clause in the contract may prove that no general customary principle exists.[16]

Hardship clauses have been defined in general terms as contractual clauses whose object is to readapt and renegotiate a contract when a change in circumstances creates a substantial imbalance of the respective parties' obligations. By means of such clauses, unforeseen circumstances taking place once the contract has been entered into are regulated. This means that a contractually agreed remedy is envisaged to avoid the consequences of circumstances that do not make the contract execution impossible but that make such an execution particularly burdensome for one of the parties. The remedies envisaged usually involve an obligation to renegotiate terms, and, in some extreme cases, the termination of the contract. In addition, such clauses are eventually a relevant 'source of information' for a third party, usually an arbitral tribunal, which shall ultimately decide on the legal consequences of such unforeseen and unexpectedly occurring circumstances.[17]

In cases where the contracts provide for a hardship clause, parties may accede to reasonable requests for renegotiation by their counterparts when the contractual and in particular financial equilibrium was seriously disrupted by external events. So renegotiation becomes for both parties a way to maintain the benefits of the contractual relationship by adapting the contractual document. It is also a way to make negotiations for contracts easier and more acceptable: If one party knows that the other party will act reasonably when a renegotiation situation arises, it will build in far less

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[16] Supra, note 1.

[17] International arbitration and changed circumstances in contract performance, Felix J. Montero Muriel Perez-Llorca, Global Arbitration Review, http://www.globalarbitrationreview.com.

protective and escape clauses into the original contract than it would be forced to do otherwise.[18]

But where parties fail to agree on a hardship clause, when may the setting aside of a contract be warranted on grounds of changed of circumstances?

As pointed out in ICC Award No. 1512, the type of relationship or the particular type of contract should be considered so as to the application of hardship remedies even though no clause was agreed. This could well be the case in technology transfer contracts, oil and gas supply agreements and civil engineering constructions contracts, where the contractual imbalance does not only appear because of unforeseen circumstances, but also because of the sensitive nature of such contracts to certain economic circumstances which have even more impact in long-term contracts.[19]

In the international milieu, where the object and parties to a contract cut across borders, parties have the option to adopt the international principles laid down in the UNIDROIT Principles of International Commercial Contracts 2004. Where a controversy arises, the parties may submit themselves to arbitration using the said principles.

The International Institute for the Unification of Private Law (UNIDROIT) is an intergovernmental agency, re-established in 1940 on the basis of a multilateral treaty. Membership is restricted to States, and some 59 are members. In 1994[20] it published its "UNIDROIT Principles of

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[18] Supra, note 8.

[19] Supra, note 17.

[20] The 1994 Unidroit Principles have been updated with the 2004 Unidroit Principles of International Commercial Contracts. As compared to the 1994 edition, the new edition contains 5 additional chapters as well as an expanded Preamble and new provisions on Inconsistent Behaviour and on Release by Agreement. Moreover wherever appropriate the 1994 edition of the Principles has been adapted to meet the needs of electronic contracting. The UNIDROIT Principles 2004 consist of the Preamble (1994 version, with the addition of paragraphs 4 and 6 as well as the footnote) and 185 articles divided into ten chapters, namely Chapter 1: "*General Provisions*" (1994 version, with the addition of Arts. 1.8 and 1.12); Chapter 2, Section 1: "*Formation*" (1994 version) and Section 2: "*Authority of Agents*" (new); Chapter 3: "*Validity*" (1994 version); Chapter 4: "*Interpretation*" (1994 version); Chapter 5, Section 1: "*Content*" (1994 version, with the addition of Art. 5.1.9) and Section 2: "*Third Party Rights*" (new); Chapter 6, Section 1: "*Performance in General*" (1994 version) and Section 2: "*Hardship*" (1994 version);

International Commercial Contracts," composed of a Preamble and 119 articles, with the aim of providing a general regulation of contractual law. The structure and style are similar to that of European civil codes, although the UNIDROIT Principles are unique in that each article is accompanied by comments and by case descriptions, intended to explain the basic rules. The UNIDROIT Principles are most certainly not an international treaty; neither are they a compilation of international usages. They are a restatement of existing international law, selecting those rules which the working group designated by UNIDROIT found most persuasive or best suited for cross border transactions and acceptable to both civil and common law lawyers. If the UNIDROIT Principles are such a convincing piece of draftsmanship, it is because the aim was not to find the broadest compromise but the most fitting solution. The purpose of the UNIDROIT Principles is clearly established in its Preamble: parties may agree to apply them in their international contracts, and in such case they become mandatory (*ex lege contractus*). Courts and arbitrators "may" apply them, when the agreement of the parties is "that their contracts be governed by general principles of law, the lex mercatoria or the like", when "it proves impossible to establish the relevant rule of applicable law", or when it is necessary "to interpret or supplement international uniform law".[21]

Section 2, Article 6.2.2 of the 2004 Unidroit Principles of International Commercial Contracts defines Hardship as:

> **Definition of Hardship-** There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and (a) the events occur or become known to the disadvantaged

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Chapter 7, Section 1: "*Non-performance in General*" (1994 version), Section 2: "*Right to Performance*" (1994 version), Section 3: "*Termination*" (1994 version) and Section 4: "*Damages*" (1994 version); Chapter 8: "*Set-off*" (new); Chapter 9, Section 1: "*Assignment of Rights*" (new), Section 2: "*Transfer of Obligations*" (new) and Section 3: "*Assignment of Contracts*" (new); Chapter 10: "*Limitation Periods*" (new), lifted from http://www.unidroit.org/english/principles/contracts/main.htm.

[21] See Separate Arbitral Award Rendered in 2001 IN SCC CASE 117/1999, http://www.sccinstitute.com/_upload/shared_files/artikelarkiv/scc_case_117_1999.pdf

> party after the conclusion of the contract; (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;(c) the events are beyond the control of the disadvantaged party; and (d) the risk of the events was not assumed by the disadvantaged party.
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> Further, Article 6.2.3 of the principle says:
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> **Effects of Hardship-** (1) In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based; (2) The request for renegotiation does not itself entitle the disadvantaged party to withhold performance. (3) Upon failure to reach agreement within a reasonable time either party may resort to the court. (4) If the court finds hardship it may, if reasonable, (a) terminate the contract at a date and on terms to be fixed; or (b) adapt the contract with a view to restoring its equilibrium.[22]

Similar solutions, as reflected above, have been considered under the Principles of European Contract Law drafted by the Commission On European Contract Law led by Professor Ole Lando; the principles compiled under the codification platform for transnational commercial law (Transnational Law Data Base) launched under the aegis of the Center for Transnational Law (CENTRAL) at the University of Cologne and led by Professor Klaus Peter Berger; and the UNCITRAL Legal Guide on Drawing Up International Contracts for the Construction of Industrial Work, prepared by UNCITRAL. In all four legal materials the consequences are, above all, the existence of a duty to renegotiate the contract and if no settlement is reached, court and arbitral tribunals may either terminate or adapt the contract, and in certain cases damages may be awarded for the loss suffered through a party refusing to negotiate or breaking off negotiations contrary to good faith and fair dealing.[23]

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[22] http://www.unidroit.org/english/home.htm

[23] Supra, note 19.

A short note on UNCITRAL and the United Nations Convention on Contracts for the International Sale of Goods (CISG)

The United Nations Commission on International Trade Law (UNCITRAL) was established by the General Assembly in 1966 (Resolution 2205(XXI) of 17 December 1966). In establishing the Commission, the General Assembly recognized that disparities in national laws governing international trade created obstacles to the flow of trade, and it regarded the Commission as the vehicle by which the United Nations could play a more active role in reducing or removing these obstacles. (*See www.uncitral.org*)

In ICC Arbitration Case No. 6281 of 1989,[24] the Court of Arbitration of the International Chamber of Commerce, classified issues using UNCITRAL classification code numbers, among them, 79G on impediments to excusing party from damages: other problems (in this case, hardship and related issues).

The parties, of Egyptian and Yugoslav nationality, concluded a contract for the FOB sale of a certain quantity of steel. In conformity with the contract, the buyer announced that it wished to exercise its right to buy an additional quantity of steel at the price and on the conditions stipulated in the contract. The dispute arose from the seller's refusal to deliver the additional quantity of steel at the contract price, since the market price had gone up, as a result of which the buyer was forced to obtain the goods from another source at a higher price.

The tribunal found that, pursuant to Article 100(2) CISG, the Convention was not applicable, since the contract was concluded before the Convention entered into force in the countries involved (including France, the place of arbitration), even though those countries were parties to the Convention at the time of issuance of the arbitral award. Applying the private international law rules of the countries concerned and Article 3.1 of the Hague Convention of 15 June 1955 on the law applicable to international sales of goods, to which France is a party, the tribunal concluded that the applicable law was the law of Yugoslavia, as the law of

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[24] Lifted from Case law on UNCITRAL texts (CLOUT) abstract no. 102 http://cisgw3.law.pace.edu/cases/896281i1.html

the place where the seller had its principal place of business and where the contract was performed.

The tribunal compared the Yugoslav law with Article 74.1 of the Uniform Law on the International Sale of Goods (ULIS) and with Article 79(1) CISG and found that by refusing to deliver the additional goods at the contract price the seller had committed a breach of contract. The tribunal held that the seller could be relieved of the obligation to deliver the goods at the contract price only if the contract contained a price adjustment clause, or in case of frustration of the contract, which was not the case here, since the increase in the market price was, in fact, neither sudden nor substantial nor unforeseeable.

A side trip to *Force majeure*

It is often believed that the term *force majeure* is solely of a contractual nature, so that parties to a contract are free to stipulate that a certain event shall be regarded as *force majeure*, irrespective of the conditions which have to be met under the applicable law. The legal elements for the qualification of an event as *force majeure* (*vis maior*, act of God, etc.) are essentially the same in most legislations, and court decisions show a universal trend to a comparable restrictive interpretation. These elements are (i) that the event is of an external nature, (ii) that it could not be foreseen or prevented and (iii) that it renders performance of a contractual obligation impossible at all or for a certain time.[25]

Force majeure is thus distinguished from a hardship clause, where in the latter performance may still be possible but particularly burdensome to one of the parties. Under the *force majeure* principle, it may be said that renegotiating the contact may be futile as the happening of the "event" has rendered the performance absolutely impossible or at least, for the time being. If there is impossibility of performance at a certain time, the

[25] Force Majeure and Hardship Clauses in international Contracts in view of the practice of the ICC Court of Arbitration, Warner Melis, http://www1.fidic.org/resources/contracts/melis.

remedy contemplated may be to suspend the effectivity of the contract until such time performance becomes possible at a later date.

In this jurisdiction, the Civil Code of the Philippines, under Article 1174 on Chapter 2 on the Nature and Effects of Obligations, provides that "except in cases expressly specified by the law, or when it is otherwise declared by stipulation, or when the nature of the obligation requires the assumption of risk, no person shall be responsible for those events which could not be foreseen, or which foreseen, were inevitable."

Owing to the fact that there is a seemingly dearth of uniformity in the treatment of hardship and *force majeure* clauses in international trade and international commercial contracts, a clamour for the standardization of *force majeure* and hardship clauses in international contracts has more recently been evident. The object of standardization being to allow parties to have immediate access to information as to the consequences of certain events-whether falling under *force majeure* or hardship clauses- in their contractual rights and obligations. Where the realm of the unknown is lessened to a degree, parties to a contract have more confidence that each will do that which he has promised.

It is precisely for this reason that the ICC Court of Arbitration Commission on International Commercial Practice has set up draft models on *force majeure* and hardship clauses which may be recommended to the business world for incorporation in international contracts.

Thus was born the ICC Force Majeure Clause 2003, ICC Hardship Clause 2003, ICC Publication No. 650, which provides for two model clauses: 1) a *Force Majeure* Clause, which lays down the conditions for release from liability when performance of a contractual obligation has become impossible; and 2) a Hardship Clause, which is intended to cover cases where unforeseen events so fundamentally alter the equilibrium of a contract that an excessive burden is placed on one of the parties.

The jurisdiction of the ICC Court of Arbitration covers business disputes of an international character (Art.1(1) of its Rules); the arbitrators can be of any nationality (Art. 2), the parties are free to determine the law to be applied by the arbitrators to the merits of the dispute. In the absence of such determination by the parties, the arbitrators shall apply the law designated as the proper law by the rules of conflict which they deem appropriate (Art.13 (3)). They shall have the power of an *amiable*

compositeur only if the parties are agreed to give them such powers (Art.13 (4)). Finally, "in all cases the arbitrator[s] shall take account of the provisions of the contract and the relevant trade usages" (Art. 13 (5)).[26]

In a study of ICC cases, the author thereat drew the conclusion that ICC arbitrators apply at least the same restrictive criteria for admission of *force majeure* or hardship as do courts in the country whose law they apply.[27]

Philippine national law and jurisprudence on changed circumstances

In a Supreme Court ruling, the highest magistrate held that under the theory of *rebus sic stantibus,* the parties stipulate in the light of certain prevailing conditions, and once these conditions cease to exist the contract also ceases to exist.[28] This theory is said to be the basis of Article 1267 of the Civil Code, which provides:

> *ART. 1267. When the service has become so difficult as to be manifestly beyond the contemplation of the parties, the obligor may also be released therefrom, in whole or in part*.

Thus, in the case of *Philippine National Construction Corporation vs. CA, et.al., GR No. 116896, May 5, 1997,* the Philippine Supreme Court had occasion to ruminate on the principle of change circumstances.

In the said case, Petitioner PNCC as lessee entered into a lease contract with private respondents as lessors covering an undivided portion of 30,000 square meters of a parcel of land owned by the private respondents. On 7 January 1986, petitioner obtained from the Ministry of Human Settlements a Temporary Use Permit for the proposed rock crushing project. The permit was to be valid for two years unless sooner revoked by the Ministry.

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[26] Ibid.

[27] Ibid.

[28] Naga Telephone Co. v. Court of Appeals, 230 SCRA 351, 365 [1994] citing IV TOLENTINO 347.

On 16 January 1986, private respondents wrote petitioner requesting payment of the first annual rental in the amount of ₱240,000 which was due and payable upon the execution of the contract. They also assured the latter that they had already stopped considering the proposals of other aggregates plants to lease the property because of the existing contract with petitioner.

In its reply-letter, petitioner argued that under paragraph 1 of the lease contract, payment of rental would commence on the date of the issuance of an industrial clearance by the Ministry of Human Settlements, and not from the date of signing of the contract. It then expressed its intention to terminate the contract, as it had decided to cancel or discontinue with the rock crushing project "due to financial, as well as technical, difficulties.

The private respondents refused to accede to petitioner's request for the pre-termination of the lease contract. They insisted on the performance of petitioner's obligation and reiterated their demand for the payment of the first annual rental.

Petitioner objected to the claim of the private respondents and argued that it was "only obligated to pay ... the amount of ₱20,000.00 as rental payments for the one-month period of lease, counted from 07 January 1986 when the Industrial Permit was issued by the Ministry of Human Settlements up to 07 February 1986 when the Notice of Termination was served" on private respondents.

Invoking Article 1266 and the principle of *rebus sic stantibus*, petitioner asserts that it should be released from the obligatory force of the contract of lease because the purpose of the contract did not materialize due to unforeseen events and causes beyond its control, *i.e.*, due to abrupt change in political climate after the EDSA Revolution and financial difficulties. Ruling in favor of the private respondents, the Court held:

> "It is a fundamental rule that contracts, once perfected, bind both contracting parties, and obligations arising therefrom have the force of law between the parties and should be complied with in good faith. But the law recognizes exceptions to the principle of the obligatory

force of contracts. One exception is laid down in Article 1266 of the Civil Code, which reads: "The debtor in obligations to do shall also be released when the prestation becomes legally or physically impossible without the fault of the obligor."

Petitioner cannot, however, successfully take refuge in the said article, since it is applicable only to obligations "to do", and not to obligations "to give". An obligation "to do" includes all kinds of work or service; while an obligation "to give" is a prestation which consists in the delivery of a movable or an immovable thing in order to create a real right, or for the use of the recipient, or for its simple possession, or in order to return it to its owner.

The obligation to pay rentals or deliver the thing in a contract of lease falls within the prestation "to give"; hence, it is not covered within the scope of Article 1266. At any rate, the unforeseen event and causes mentioned by petitioner are not the legal or physical impossibilities contemplated in said article. Besides, petitioner failed to state specifically the circumstances brought about by "the abrupt change in the political climate in the country" except the alleged prevailing uncertainties in government policies on infrastructure projects.

The principle of *rebus sic stantibus* neither fits in with the facts of the case. Under this theory, the parties stipulate in the light of certain prevailing conditions, and once these conditions cease to exist the contract also ceases to exist. This theory is said to be the basis of Article 1267 of the Civil Code, which provides:

ART. 1267. When the service has become so difficult as to be manifestly beyond the contemplation of the parties, the obligor may also be released therefrom, in whole or in part.

This article, which enunciates the doctrine of unforeseen events, is not, however, an absolute application

> of the principle of *rebus sic stantibus*, which would endanger the security of contractual relations. The parties to the contract must be presumed to have assumed the risks of unfavorable developments. It is therefore only in absolutely exceptional changes of circumstances that equity demands assistance for the debtor.
>
> Anent petitioner's alleged poor financial condition, the same will neither release petitioner from the binding effect of the contract of lease. As held in Central Bank v. Court of Appeals, cited by the private respondents, mere pecuniary inability to fulfill an engagement does not discharge a contractual obligation, nor does it constitute a defense to an action for specific performance.
>
> With regard to the non-materialization of petitioner's particular purpose in entering into the contract of lease, *i.e.*, to use the leased premises as a site of a rock crushing plant, the same will not invalidate the contract. The cause or essential purpose in a contract of lease is the use or enjoyment of a thing. As a general principle, the motive or particular purpose of a party in entering into a contract does not affect the validity or existence of the contract; an exception is when the realization of such motive or particular purpose has been made a condition upon which the contract is made to depend. The exception does not apply here.

Based on the preceding, it may be said that invoking the doctrine of changed circumstances or *rebus sic stantibus* should not be seen as an elixir or a panacea for any and all kinds of hardship that the disadvantaged party may think it had to suffer under its contractual obligations. The following points may be extracted from the ruling:

1) The SC distinguished between an obligation to do and an obligation to give, allowing applicability of the doctrine of changed circumstances only in obligations to do. Thus, the obligation to pay rentals or deliver the

thing in a contract of lease falls within the prestation "to give"; hence, it is not within the scope of Article 1266.

2) The SC also makes the principle applicable only to certain legal or physical impossibilities that are covered by Article 1266 of the Civil Code, hence not all impossibilities can fall under its protective mantle. It may thus be concluded that there will be no hard and fast rules in invoking the applicability of the rebus doctrine. Such will always be seen in light of the attendant circumstances of each case.

3) Too, it may be said that it appears the SC does not distinguish between hardship and *force majeure*, as opposed to how these doctrines are viewed in international law. There seems to be no distinction between Article 1266 in respect of legal or physical impossibility of performance, and such party is released from performance and Article 1267 where performance is rendered difficult (or burdensome), which difficulty is beyond the contemplation of the parties, and such party may be released from performance, in whole or in part.

4) Incidentally, this jurisdiction refers to *force majeure* and fortuitous events, interchangeably. In a 2005 case, the Supreme Court held that the 1997 Asian Economic crisis was not a fortuitous event. In *Mondragon Leisure and Resorts Corporation vs. Court of Appeals*[29],the Supreme Court ruled as follows:

"Petitioner's claim, that the respondents could not be held in default because of a fortuitous event, is untenable. Said event, the Asian financial crisis of 1997, is not among the fortuitous events contemplated under Article 1174 of the Civil Code. To exempt the obligor from liability for a breach of an obligation by reason of a fortuitous event, the following requisites must concur: (a)

[29] 460 SCRA 279 [2005].

> the cause of the breach of the obligation must be independent of the will of the debtor; (b) the event must be either unforeseeable or unavoidable; (c) the event must be such as to render it impossible for the debtor to fulfill his obligation in a normal manner; and (d) the debtor must be free from any participation in, or aggravation of the injury to the creditor."
>
> Worthy of note, risk is an exception to the general rule on fortuitous events. Under the law, these exceptions are: (1) when the law expressly so specifies; (2) when it is otherwise declared by the parties; and (3) when the nature of the obligation requires the assumption of risks. We find that in the Omnibus Agreement, the parties expressly agreed that any enactment, official action, act of war, act of nature or other *force majeure* or other similar circumstances shall in no way affect the obligation of the borrowers to make payments."

a) Fortuitous event as a principle in national law

A fortuitous event refers to an occurrence or happening which could not be foreseen, or even if foreseen, is inevitable. Fortuitous events may be produced by two (2) general causes: (1) by Nature, such as but not limited to, earthquakes, storms, floods, epidemics, fires, and (2) by the act of man, such as but not limited to, armed invasion, attack by bandits, governmental prohibitions, robbery, provided that they have the force of an imposition which the obligor could not have resisted.

Article 1174 of the Civil Code, as it pertains to ordinary fortuitous events or those events which ordinarily happen or which could be reasonably foreseen but are inevitable, such as, but not limited to the following: typhoons; floods; drought and similar acts of God.

Article 1250 of the same Code, as it pertains to extraordinary inflation or deflation, in case an extraordinary inflation or deflation of the currency stipulated should supervene, the value of the currency at the time of the establishment of the obligation shall be the basis of payment, unless there is an agreement to the contrary.

Article 1680, as it enumerates extraordinary fortuitous events or those events which do not usually happen, such as, fire, war, pestilence, unusual flood, locusts, earthquake, or others which are uncommon, and which the contracting parties could not have reasonably foreseen.

b) Police power versus non-impairment clause

In *United BF Homeowners' Associations, Inc. et.al. vs. The Municipal City Mayor, et.al., GR No. 141010, February 07, 2007*, Petitioners filed with the Court of Appeals a petition for prohibition with an application for temporary restraining order and preliminary injunction. Petitioners questioned the constitutionality of Municipal Ordinance No. 97-08, alleging that the reclassification of certain portions of BF Homes Parañaque from residential to commercial zone is unconstitutional because it amounts to impairment of the contracts between the developer of BF Homes Parañaque and the lot buyers. Petitioners cited the annotation on the lot buyers' titles which provides that the property shall be used for residential purposes only and for no other purpose. As the highest magistrate held:

> The Court has upheld in several cases the superiority of police power over the non-impairment clause. The constitutional guaranty of non-impairment of contracts is limited by the exercise of the police power of the State, in the interest of public health, safety, morals and general welfare.
>
> With regard to the contention that said resolution cannot nullify the contractual obligations assumed by the defendant-appellee–referring to the restrictions incorporated in the deeds of sale and later in the corresponding Transfer Certificates of Title issued to defendant-appellee–it should be stressed, that while non-impairment of contracts is constitutionally guaranteed, the rule is not absolute, since it has to be reconciled with the legitimate exercise of police power, i.e., "the power to prescribe regulations to promote the health, morals, peace, education, good order or safety and general welfare of the people. We do not see why the public welfare when

clashing with the individual right to property should not be made to prevail through the state's exercise of its police power.

c) Labor contracts- sui generis

By law and jurisprudence labor contracts have been consistently treated and imbued with public interest. Thus in the *Maritime Manning Agencies*[30] case, the Supreme Court ruled that:

> Verily, the freedom to contract is not absolute; all contracts and all rights are subject to the police power of the State and not only may regulations which affect them be established by the State, but all such regulations must be subject to change from time to time, as the general, well-being of the community may require, or as the circumstances may change, or as experience may demonstrate the necessity. And under the Civil Code, contracts of labor are explicitly subject to the police power of the State because they are not ordinary contracts but are impressed with public interest. Article 1700 thereof expressly provides:
>
> Art. 1700. The relations between capital and labor are not merely contractual. They are so impressed with public interest that labor contracts must yield to the common good. Therefore, such contracts are subject to the special laws on labor unions, collective bargaining, strikes and lockouts, closed shop, wages, working conditions, hours of labor and similar subjects.
>
> The challenged resolution and memorandum circular being valid implementations of E.O. No. 797, which was enacted under the police power of the State, they cannot be struck down on the ground that they violate the contract clause. To hold otherwise is to alter long-

[30] GR No. 114714, April 21, 1995.

established constitutional doctrine and to subordinate the police power to the contract clause.

Conclusion

From the above disquisitions, it may be said that *pacta sunt servanda* is the rule and *rebus sic stantibus* is only an exception. It appears as well that Philippine law and jurisprudence had been aligned with these principles, as they are applied under international law so that our municipal laws are consistent with the international milieu, granting only such extreme exceptions, when justified by compelling reasons, and under very strict rules or guidelines.

Too, it appears that under Philippine law on contracts, parties are generally allowed relief for changed circumstances only when they have specifically indicated such escape clauses in their binding agreements. Otherwise, the courts will enforce the contractual stipulations, except only under exceptional cases or grounds. The rebus doctrine, even in this jurisdiction is never broadly applied nor loosely interpreted. After all, the non-impairment of contracts clause is explicitly laid out in no less than our organic law.

As one commentator had noted: the take or pay cases show that protection against hardship arising from changed circumstances does not lie in assuming relief will be found [in the courts]. Protection lies in ensuring appropriate clauses are contained in the contract itself.[31] It may thus be said that the goal of contract law is not to inspire legal suits but to settle or avoid them. Well-known rules that eliminate ambiguity make it more likely that promises will be kept.[32]

If the problem of frustration is a central question of contract law in general, special attention should be given to its appearance in a particular class of contracts because of the distinctive risks and burdens parties in these contracts usually face. That class of contracts includes international trade contracts, involving the sale or transportation of goods beyond the national boundaries of a single country. The particularities of these

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[31] Supra, note 18.

[32] Freedom to Contract, Dr. Edward Younkins, Liberty Free Press, June 15, 2000, http://www.quebecoislibre.org.

contracts arise out of their two typical elements; namely, the transnational character and the long-distance nature of the stipulated shipments.[33]

The nature of the contract may have some bearing on whether the principle of change circumstances may be a valid basis for post-contractual bargaining or renegotiation.

Renegotiation clauses are provisions in contracts that, upon the happening of a certain event or events, require all parties to return to the bargaining table and renegotiate the terms of their agreements. xxx these clauses are particularly useful in international investment contracts between a private party and a government entity. the investor would then have the right to renegotiate or adapt the contract with the aim of restoring the original equilibrium between the parties. xxx using a renegotiation and adaptation clause in this manner leaves a state's sovereignty intact and protects the investor against changes in the law governing the agreement.[34]

It is advisable as well to provide for hardship or *force majeure* clauses that are specific or endemic to the particular kind of contract that is being entered into (i.e. mining contracts, service agreements, technology transfer arrangements) or an escalation clause providing for remedies in case of inflation-deflation (in a transaction for a sale of goods over a period of time, specially if across borders, long-term loans, particularly involving club loans) or construction and design-escalation clauses in construction contracts.

The expertise of the panel/team negotiating, drafting and reviewing the subject contract cannot be underscored enough. The representatives for corporations entering into international contracts must have the necessary skills and know-how with respect to the subject matter of the agreement, the market and the general principles adopted and inherent to the industry subject of the negotiation.

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[33] Supra, note 14.

[34] Renegotiation and Adaptation Clauses in Investment Contracts, Revisited, John Y. Gotanda, http://law.vanderbilt.edu/journals/journal/36-04/GOTANDA.pdf.

Surprisingly, there are international contracts that tend to be silent on the applicable or choice of law in case disagreements arise. In the UNIDROIT Principles of International Commercial Contracts, Special Supplement (2002) ICC Bulletin, 86, it is estimated- on the basis of ICC statistics - that 20% of arbitration cases lack a predetermined choice-of-law provision (*See Separate Arbitral Award, Note 3, Rendered in 2001 in SCC Case 117/1999*). This lack of choice of law provision, may by itself already give rise to a protracted contention, although some commentators are of the opinion that the lack of choice in the contract is an indication that the parties prefer to submit this issue to arbitration. This writer humbly submits, however, that it would be prudent to include a choice of law provision in the contract so as to obviate conflict on this issue, thereby hastening the process of resolving the substantial merits of the case.

In most cases where the parties expressly choose transnational law as the law governing their contract, they do so by referring to "general principles of law", "transnational principles of law", "*lex mercatoria*", "principles of international law", etc. Yet even if the contract is silent as to the applicable law, arbitrators themselves sometimes decide, particularly in the context of so-called State contracts, to base their decision on "general principles of law", the "*lex mercatoria*" or the like rather than on a particular domestic law. In both cases the question arises as to whether the UNIDROIT Principles may be used to determine the content of such rather vague concepts. xxx The view has been expressed that precisely because the UNIDROIT Principles do not at all claim to enunciate only rules which are already generally accepted at international level, what is at stake is not their direct and exclusive applicability as "general principles of law" or as the "*lex mercatoria*", but merely the possibility to resort to them as one of the various sources available to determine the content of these (or similar) rather vague formulations used by the parties. Only the future can tell whether the UNIDROIT Principles will grow into something more and something different, in the sense of establishing themselves, in their entirety, as the most genuine expression of the "general principles of law" or the *lex mercatoria* in the field of contract law. Turning to actual arbitration practice, the UNIDROIT Principles have already on several occasions been referred to as a source of "general principles of law" or the "*lex mercatoria*".[35]

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[35] The UNIDROIT Principles and Transnational Law, Michael Joachim Bonell, http://www.unidroit.org/english/publications/review/articles/2000-2.htm.

At this time, there is no universal standard that is definitive in reference to when frustration of purpose or hardship may be a legal excuse for non-performance. At the most, there are international model clauses that may be referred to when disputes arise. It would appear then that the first line of defense should be the contract itself- that is, it should, as best as parties can predict, contain all the provisions and contingencies that the contracting parties believe, having in mind the peculiarities of the subject matter and the relationship of the parties, will excuse or not excuse performance.

However, since men are frail and may not be able to cover each and every possibility, it is also paramount that parties deal with each other in a just and fair manner, bearing in mind the principles of good faith and such principles in international law/trade that have gained wide and popular acceptance.

Economic activities have become increasingly global and the "law" that provides for them should do so in the same dimension. The quest is to find or achieve a uniform legal order that is preferably delocalised, transcends state boundaries, provides cross-border transparency and world-wide effect. This idea is discussed in relative terms, the more transnational and transcending of state law, the greater the uniformity achieved, or the more a-national the "law", the more autonomous the resulting contract. Areas of particular interest are: uniform substantive rules of law; uniform interpretation of such rules and the contract; and the global enforcement of decisions. Seeking a foundation for contract that is more autonomous of individual states, with the aim of attaining greater efficiency, consistency and predictability in international business transactions, and thereby, insofar as it is possible, to transcend the relevance of borders.[36]

In fine, commercial contracts must express the will of the parties, and should circumstances arise that may prevent this will from being fulfilled, an allowance for such fact may be a starting point for reconsideration. In her 1998 book, *The Future and Its Enemies*, Virginia Postrel explains that, by treating individuals as free and equal generic

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[36] The Autonomous Contract- Reflecting the borderless electronic-commercial environment in contracting, Ralph Amissah, http://www.cisg.law.pace.edu.

units, contract permits people to create arrangements far beyond the plans of any grand designers. Only by treating individuals in this manner can over-arching rules allow people to use their own knowledge, express their individuality, and take advantage of their own ideas by joining them and their property in various unanticipated ways.[37]

[37] Supra, note 32.