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### **Hardship and Changed Circumstances as Excuse for Non-Performance of Contracts - Practical Considerations in International Infrastructure Investment and Finance** by F.R. Fucci

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Grounds for Adjustment or Non-Performance of Contracts**

**Practical Considerations in International  
Infrastructure Investment and Finance**

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Investment in infrastructure is necessarily long-term. Most governments, lacking the resources and the expertise to finance and maintain infrastructure on their own, seek to attract foreign capital and expertise. To do so, they need to offer the possibility of predictable revenue streams over time frameworks ranging from five to thirty years, depending on the nature of the investment, with international developers and banks looking to the longer end of that spectrum. Therefore, in typical contracts related to investment – concessions, offtake agreements and production sharing arrangements – the investors and host governments (or their agencies) establish a pricing scheme that assures investors adequate revenue to cover their debt service obligations, a reasonable return on the equity capital invested in view of the risk profile and the possibility of an eventual return of that capital to the investor. Sophisticated investors and lenders require that these pricing schemes allow for adjustment over the life of the contract, typically for the effects of inflation, changes in currency valuation and other changes in law.

In many cases, however, the effect of changing circumstances is not entirely spelled out in contracts. In that case, investors and lenders must look to the legal regime covering their relations with the host state. Typically, the law of the so-called project contracts is that of the host state while, just as typically, the law of the international financial facilities and guarantees is that of either New York or England or sometimes France, depending on what part of the world the project is found.

Therein lies a dichotomy and the source of many conflicting understandings among practitioners as to the preservation of long-term contracts. In countries with a common law legal tradition, where the major international commercial lenders, multilateral banks and their attorneys are based, a contract, particularly one with a fixed price, is understood as allocating the risk of unforeseen events between the parties. Practitioners from those jurisdictions are trained to think that except in the most extreme circumstances, the terms of the contract should be enforced, that it is up to the parties to guard against risks by inserting price adjustment and other clauses to protect themselves. Except perhaps for the rarely invoked common law doctrine of reformation of contract, there is no recognized legal theory or mechanism for a contract to be adjusted by a court or an arbitral tribunal. In the United States for instance, it is virtually unheard of for a court to adjust a contractual term due to a change in circumstances. In all of the voluminous compilations of American jurisprudence, there is only one prominent decision to this effect (during the oil crisis of the 1970's) – and this has been roundly criticized by

commentators.<sup>1</sup> If the change in circumstance is extreme, either the contract is avoided (especially in bankruptcy) or it is enforced.

Many states receiving foreign investment in infrastructure have civil law traditions, meaning legal systems originally inspired by the French civil code and its Roman origins. As this tradition has evolved, and without taking into account differences between the various municipal legal systems, the philosophy tends to be that when a contract is entered into, it sets an economic balance between the parties. In a long-term contract, if the economic balance is significantly disturbed by unforeseen events, the contract may be adjusted to preserve it. If the parties cannot agree on the scope of the adjustment, they have recourse to courts or administrative tribunals to re-establish the balance. Practitioners trained in common law countries tend to be very suspicious of this concept and seek to contain it or neutralize it through contract drafting. If they do not address it, then the general legal principles established in the host country prevail.

Difficult questions arise when the assumptions made in contracts are overwhelmed by events, either man-made or natural. Recent history provides a wealth of examples, starting with the Russian crisis in the mid-90's, the Asian "contagion" that led to the collapse of the Indonesian economy, the devaluation of the Real in Brazil and later drought-inspired power shortages and, of course, the Argentine crisis starting in 2000. Many disputes have arisen between investors and host governments or their agencies as a result of these events, some of which have resulted in published arbitral awards.

Much has been written over time about the doctrine of hardship and how it should be applied, as well as the broader issue of how to allocate risk in long-term contracting.<sup>2</sup> In order to inject some fresh perspective in what is a longstanding focus of scholarship, the methodology of this paper will be to look at recent attempts by parties to international infrastructure agreements to invoke the doctrine of hardship as an excuse for non-performance, to follow how the dispute has been resolved and to analyze what the ultimate outcome proved to be.<sup>3</sup> Even though these disputes have arisen in projects from many different countries, there are common threads. These observations are then applied to some of the questions that experience has shown to be of the greatest concern to investors when confronting the prospect of changed circumstances, either in a

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<sup>1</sup> *Aluminum Company of America (Alcoa) v EssexGroup, Inc.*, 499 F.Supp 53 (W.D. Pa. 1980), discussed infra.

<sup>2</sup> See e.g. Klaus Peter Berger, *Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators*, 36 VANDERBILT JOURNAL OF TRANSNATIONAL LAW 1347 (Oct. 2003); John Gotanda, *Renegotiation and Adaptation Clauses in Investment Contracts, Revisited*, *Id.* at 1461; Nagla Nassar, SANCTITY OF CONTRACTS REVISITED: A STUDY IN THEORY AND PRACTICE OF LONG-TERM INTERNATIONAL COMMERCIAL TRANSACTIONS (Martinis Nijhoff 1995); Wolfgang Peter, ARBITRATION AND RENEGOTIATION OF INTERNATIONAL INVESTMENT AGREEMENTS (Kluwer); Robert A. Hillman, *Court Adjustment of Long-Term Contracts: An Analysis under Modern Contract Law*, 1987 DUKE LAW JOURNAL 1; Clayton Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINNESOTA LAW REVIEW 521 (Feb. 1985)

<sup>3</sup> This paper will not attempt to go over some of the older arbitral jurisprudence resulting from investment disputes from the 1960's-1980's, which is familiar to international practitioners and ably described elsewhere. See, for instance, Abba Kolo and Thomas W. Wälde, *Renegotiation and Contract Adaptation in International Investment Projects – Applicable Legal Principles and Industry Practices*, 1 JOURNAL OF WORLD INVESTMENT 5-57 (July 2000).

contract negotiation or a dispute. Section II of this paper is organized according to those questions. The analysis and the learning of recent arbitral awards are applied to each of them.

Before the specific questions are addressed, the paper begins with a brief theoretical exposition, focusing first on the development of the doctrine in civil law countries, and then with a short explanation of the ways in which the common law tradition has handled the problem of changed circumstances in contract performance, principally the doctrine of commercial impracticability. The paper then discusses how the participants in the UNIDROIT process have attempted to establish principles that reconcile the two competing legal traditions and also cites the code or other legal principles of domestic legal systems that incorporate hardship into their laws. The purpose of this exercise is to show that everywhere attorneys are struggling to deal with the most fundamental problem in long-term contracting – how to manage change.

The last section of the paper attempts to synthesize the analysis presented in the form of considerations that attorneys drafting contracts need to take into account in order to ensure the greatest level of stability in long-term contract performance – or to minimize the potential disruptions associated with claims of hardship as an excuse for non-performance

In sum, this paper is being presented in the belief that if there is a greater awareness and understanding of the relatively arcane doctrine of hardship, some of the more undesirable aspects of claims of changed circumstances can be avoided, or at least managed so as to preserve most of the benefits expected by both parties at the outset of the long term investment agreement. While most hardship disputes arise in the international context when host states or their enterprises seek to avoid or change contractual obligations, it is submitted that well-drafted hardship and adjustment clauses promote the goal of stability of contract for both investors and host countries and encourage long term investment in infrastructure.

## I. HARDSHIP DEFINED

### A. Development of Theory

The origins of the theory of hardship are found in how Roman law evolved. The basic principle was that if performance of a contract was possible, but a fundamental change in the circumstances surrounding the contract had rendered performance much more burdensome, so that continued performance by the party affected would amount to an undue hardship, then the affected party could invoke the principle of *clausula rebus sic stantibus*. This means that the contract contained an implied term (*clausula*) that certain important circumstances must remain unchanged (*sic stantes*).<sup>4</sup> As one author has pointed out, that principle found its way into codifications of private law in the 18<sup>th</sup> century, but was subsequently criticized because of its vagueness and lack of clarity and fell out of disfavor in the 19<sup>th</sup> century, when liberal theories

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<sup>4</sup> Norbert Horn, *Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law*, p. 17 in ADAPTATION AND RENEGOTIATION OF CONTRACTS IN INTERNATIONAL TRADE AND FINANCE, ed. by Norbert Horn (Kluwer 1985)

emphasized party autonomy.<sup>5</sup> It was then resurrected in the 20<sup>th</sup> century as a result of the disruptions caused by the First World War on the basis of a French administrative court ruling in a dispute between a private power company and the City of Bordeaux, France.

The City had granted the company, known as the *Compagnie générale d'éclairage de Bordeaux* or "Gaz de Bordeaux", as it has come to be known in the literature, a concession to provide gas lighting to the City of Bordeaux. The concession contract had a fixed price, but also provided an adjustment mechanism beyond a certain range of price fluctuation. The dispute arose in 1916. As a result of the First World War, the price of coal used by Gaz de Bordeaux more than tripled, which itself exceeded the price established for its revenues under the concession contract. The dispute, being one that related to a concession for a public service, was heard by administrative tribunals and ultimately the French *Conseil d'Etat*. The *Conseil d'Etat* decided that the adjustment mechanism in the concession agreement was insufficient under the circumstances such that its economic viability was undermined. Gaz de Bordeaux could not be required to perform the services under the original conditions. Quoting the relevant section of its decision:

"... Just as the Company cannot not argue that it should not be required to bear any increase in the price ... it would be totally excessive if it is admitted that such increases are to be considered a normal business risk; on the contrary, it is necessary to find a solution that puts an end to temporary difficulties, taking into account both the general interest ... and the special conditions that do not allow the contract to operate normally ...; to this end it is necessary to decide, on the one hand, that the Company is required to provide the concession service and, on the other hand, that during this period it must bear only that part of the adverse consequences that a reasonable interpretation of the contract allows ..."<sup>6</sup>

The *Conseil d'Etat* set out the elements of the circumstances that would permit a temporary adjustment of administrative contracts, particularly those involving concessions. The event had to be unforeseeable and external to the parties, exceed all reasonable expectations and result in a profound unbalancing of the contract. The solution should be temporary so as to preserve the long-time viability of the contract. Due to the emphasis on the unforeseeability of the event in these elements, the doctrine has come to be known as the *théorie de l'imprévision* in French, referred to as "hardship" in English.

The upshot of the Gaz de Bordeaux case was that the *Conseil d'Etat* decided that the City of Bordeaux should pay compensation and that Gaz de Bordeaux and the City should reach agreement on the amount. If they could not, it was to be fixed by a judge.

Today, hardship clauses are mandatorily part of French administrative law contracts, that is to say contracts between private parties and government entities or state-enterprises, governed

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<sup>5</sup> *Id.*

<sup>6</sup> Conseil d'Etat, *Compagnie générale d'éclairage de Bordeaux*, Rec. 125, concl. Chardenet, 30 March 1916, quoted in M. Long, P. Weil et al., *Les Grands Arrêts de la Jurisprudence Administrative* (2003) at 188-89. Translation from the award in ICSID Case No. ARB/01/8, *CMS Gas Transmission Company v The Argentine Republic* (May 12, 2005).

by administrative law. These clauses are thought to be protective of concession-holders although, in theory, they can operate in both directions, i.e. either the private party or the government can invoke them. The key point of the French administrative law doctrine is that the private contractor has a right to an indemnity from the state or its enterprise if it establishes both that (1) the difficulties encountered were “exceptional and unforeseeable” and (2) that they “upset the financial equilibrium of the contract”.<sup>7</sup>

There is no statutory provision or definition of hardship for commercial contracts under French law, although there is a general principle of French law that a contracting party is liable in damages for the non-performance or delay in performance of an obligation “whenever it does not demonstrate that the non-performance comes from an external cause which may not be imputed to it.”<sup>8</sup> Hardship clauses are routinely inserted into commercial contracts between private parties governed by French law. If a contract governed by French law contains no hardship clause, French courts would not read one into it, unlike in the case of force majeure, which is part of the French civil code and thus applicable to all contracts.<sup>9</sup>

In terms of international infrastructure investment, one can expect that practically every country that was a former French colony has some variant of these principles. In addition, many countries that are significant importers of capital have legal systems originally inspired by French law and principles on hardship embedded in their civil codes or jurisprudence. For this reason, some emphasis is given in this paper to French law as a type of flagship standard for civil law jurisdictions, with the understanding, of course, that each country’s statutes on hardship and its jurisprudence interpreting it can differ in some ways. In fact, as will be seen, French law puts a heavy emphasis on sanctity of contract and its application of the hardship doctrine is actually rather strict compared to various other domestic laws.

## B. Common Law Doctrine

An exposition of the origins of the common law doctrines such as frustration of purpose and impossibility, which were developed to offer relief to contracting parties affected by unforeseen events, would be well beyond the scope of this paper. The following presentation of the modern doctrine of commercial impracticability, which is the modern American doctrine most commonly evoked to avoid contractual liability due to changed circumstances, is intended to illustrate the legal mindset that common law attorneys bring to contractual questions, namely that changed circumstances can excuse performance, but that the contract cannot be adjusted. In crude terms, many common law attorneys believe that a contract either is performed, with the adverse consequences being absorbed by one party, or the burdened party is relieved of performance, unless there is some clear exculpatory clause or some other contractual adjustment mechanism.

Section 2-615 of the Uniform Commercial Code (UCC) pertaining to sales of goods (“Excuse by Failure of Presupposed Conditions”) is the starting point of any discussion of the

<sup>7</sup> CE, 21 juillet 1970, *Dpt Hautes Alpes c/ Ste savoyarde d'entreprise*: Rec. CE, p. 533; 28 juillet 1989, *Ville de Menton c/ Ivaldi et a.*, req. no. 49650 : RD publ. 1990, p. 291.

<sup>8</sup> Article 1147, French Civil Code.

<sup>9</sup> Article 1148, French Civil Code



modern law of commercial impracticability in the United States. Following is the core provision of the New York UCC relating to impracticability:

Except so far as a seller may have assumed a greater obligation . . .

- (a) Delay in delivery or non-delivery in whole or in part by a seller . . . is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.

As explained in the official commentary, this section “excuses a seller from timely delivery of goods contracted for, where his performance has become commercially impracticable because of unforeseen supervening circumstances not within the contemplation of the parties at the time of contracting.”

Courts in the United States do not construe § 2-615 liberally. This stance is consistent with courts’ rare application of the common law doctrine of impracticability prior to the adoption of the U.C.C.: “The principal reason was the deeply held judicial belief that one of the main functions of the law of contracts was to allocate the various risks of performance, and that only the most compelling cases, involving a substantial degree of cost discrepancy, should escape this allocation of risk.”<sup>10</sup> Further, it is widely held that increased cost alone does not constitute impracticability.<sup>11</sup> Official Comment 4 to § 2-615 of the U.C.C. specifically asserts that a rise or collapse in a market is not an excuse for non performance, “for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover.”

One of the leading cases interpreting § 2-615 is under New York law.<sup>12</sup> The dispute in that case arose from an agreement by a milk supplier, Maple Farms, to supply milk to a public school district for the school year beginning in September 1983. Due to general inflationary trends in the United States, unanticipated crop failures and an agreement by the United States to sell substantial amounts of grain to the Soviet Union, the price of raw milk increased 23% within six months of the date of contract. The supplier asked to be relieved of the contract. On the school district’s refusal, the supplier sued for declaratory judgment excusing further performance under U.C.C. § 2-615.

The court established three requirements before non-performance is justified on the ground of impracticability: “First, a contingency — something unexpected must have occurred.

<sup>10</sup> Wallack, *The Excuse Defense in the Law of Contracts: Judicial Frustration of the U.C.C. Attempt to Liberalize the Law of Commercial Impracticability*, 55 NOTRE DAME LAW REVIEW 203, 207 (1979).

<sup>11</sup> *W.R. Grace and Co. v. Local Union 759*, 461 U.S. 757 (1983). Business persons are generally charged with the knowledge that market conditions and prices will change. See *Bennett v. Howard*, 175 Ky. 797, 195 S.W. 117 (1917) (unless businessman guards against bad markets by contract, he necessarily takes the risk).

<sup>12</sup> *Maple Farms Inc. v. City School District*, 76 Misc. 2d 1080, 352 N.Y.S.2d 784 (Sup. Ct. Chemung Co. 1974).

Second, the risk of unexpected performance must not have been allocated either by agreement or by custom. Finally, occurrence of the contingency must have rendered performance commercially impracticable.”<sup>13</sup> Moreover, the burden of proof as to each of the three requisite elements rests on the party making the claim.<sup>14</sup> Because the contingency must be unexpected, this burden is extremely difficult to meet for a supplier claiming excuse for non-performance.

In the *Maple Farms* case, which in the end involved a 23% increase in the supplier’s input prices, the court held the supplier to the contract. The court did not agree that the contingencies were totally unexpected given a 10% increase in milk the previous year and the general inflationary trend. As to allocation of risk, the court deemed the risk of increase in price to be allocated to the supplier.<sup>15</sup> The purpose of the fixed price contract was to guard against price fluctuations and the supplier had not bargained for an exculpatory clause to excuse it from performance in the event of an abnormal increase in milk prices.<sup>16</sup>

In those American cases in which commercial impracticability has been found, price changes must be “especially severe and unreasonable” before relief can be granted.<sup>17</sup> There apparently are no cases “where something less than a 100% cost increase has been held to make a seller’s performance ‘impracticable,’”<sup>18</sup> Official Comment 4 to § 2-615 would not have performance excused because of increased cost “unless the rise in cost is due to some unforeseen contingency which alters the essential nature of performance.” Contingencies resulting in a drop in market prices are not treated differently from those resulting in an increase in market prices.<sup>19</sup>

All of the cases in which there is a finding of impracticability talk about “relief” or “excuse” from performance of the obligation. The drafters of the UCC did intend, however, that there be situations in which some type of adjustment to a contract is allowed. For instance, official comment No. 6 to §2-615 states that:

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<sup>13</sup> Quoting *Transatlantic Financing Corp. v United States*, 363 F.2d 312, 315 (D.C. Cir. 1966)

<sup>14</sup> *Louisiana Power & Light Co. v. Allegheny Ludlum Industries*, 517 F. Supp. 1319, 1324 (E.D. La. 1981) (interpreting New York law); *Eastern Air Lines, Inc. v. Gulf Oil Corp.*, 415 F. Supp. 429 (1975) (burden of proving each element of claimed commercial impracticability on party claiming excuse).

<sup>15</sup> *Maple Farms*, 352 N.Y.S.2d 7-90.

<sup>16</sup> Comment 8 of the official comment to § 2-615 provides:

[T]he exemptions of this section do not apply when the contingency in question is sufficiently foreshadowed at the time of contracting to be included among the business risks which fairly are to be regarded as part of the dickered terms, either consciously or as a matter of reasonable commercial interpretation from the circumstances.

<sup>17</sup> *Louisiana Power & Light Co.*, *supra* (quoting *Gulf Oil Corp. v. Federal Power Commission*, 363 F.2d 588, 600 (3d Cir. 1977), *cert. denied*, 434 U.S. 1062 (1978)). The standard announced by British courts in Suez Canal closing cases is also strict. The unforeseen cost increase that would excuse performance “must be more than merely onerous or expensive. It must be positively unjust to hold the parties bound.” *Ocean Tramp Tankers v. V/O Sorfracht (The Eugenia)*, 2 Q.B. 226, 239 (1964).

<sup>18</sup> *Publicker Industries v. Union Carbide Corp.*, 17 U.C.C. Rep. Ser. 989 (E.D. Pa. 1975)

<sup>19</sup> *Hancock Paper Co. v. Champion International Corp.*, 424 F. Supp. 285 (E.D. Pa. 1976).

In situations in which neither sense nor justice is served by either answer when the issue is posed in flat terms of 'excuse' or 'no excuse', adjustment under the various provisions of this Article is necessary, especially the sections on good faith, on insecurity and assurance and on the reading of all provisions in the light of their purposes, and the general policy of this Act to use equitable principles in furtherance of commercial standards and good faith.

This is an interesting statement and reflects the general bias of the UCC drafters towards facilitating commercial transactions by applying greater flexibility in contract interpretation, as opposed to the stricter common law theories. The statement almost sounds civil law-ish, with its emphasis on the principle of good faith in contract performance. Courts in the United States, however, are extremely reluctant to substitute their judgment for that of the contracting parties or to disturb bargained for allocations of risk. Indeed, there is really only one significant American case in which a court found that an increase in cost of performance was sufficient to allow reformation of the contract terms, as opposed to relief due to impracticability, of which there are many examples. That reformation case is *Aluminum Company of America (ALCOA) v. Essex Group, Inc.*<sup>20</sup>

Due to the 1973 Oil Embargo and unanticipated pollution control costs, ALCOA's non-labor production costs associated with performance of a contract to convert raw material into aluminum rose 600% from 1968 to 1978. Although the contract contained a price index, the non-labor production costs were not proportionately represented in the price index. In 1978, non-labor costs exceeded the costs allowable in the index by 270%.

ALCOA sued to be excused from performance or, alternatively, for reformation of the price index to reflect actual production costs. The court granted reformation. An important factor influencing the court's decision was the fact that the loss suffered by ALCOA was matched by a windfall to Essex,<sup>21</sup> so this case can be understood in the light of the general policy of the UCC to use equitable principles in furtherance of commercial standards and good faith.

### C. UNIDROIT Principles

Another useful point of reference regarding the doctrine of hardship as it is understood today in the international context is the UNIDROIT Principles of International Commercial Contracts (the "UNIDROIT Principles"), published in 1994 by the International Institute for the Unification of Private Law in Rome and updated in 2004. These principles reflect an attempt by scholars to reconcile basic commercial law provisions from common law and civil law jurisdictions and to arrive at a uniform set of principles governing international commercial contracts. While the UNIDROIT Principles do not have force of law, they have attained in the more than ten years since their publication a certain deference among international practitioners as a useful restatement of the *lex mercatoria* and are accompanied by instructive commentary and illustrations.

<sup>20</sup> 449 F. Supp. 53 (W.D. Pa. 1980).

<sup>21</sup> *Id.* at 59, 66, 79.

The section of the UNIDROIT Principles dealing with hardship begins by stating a general principle that a party remains bound to perform its contractual obligations even when the performance of the contract becomes more “onerous” for it, subject to the more specific provisions on hardship.<sup>22</sup> The Principles then go on to define this “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 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 events was not assumed by the disadvantaged party.<sup>23</sup>

#### **D. National Legal Systems**

It should also be noted that many legal systems have provisions of law or judicially established guidelines on hardship. For example, Dutch law contains a specific statutory provision allowing revision of a contract due to change in circumstances.<sup>24</sup>

1. The Court may, upon request of one of the parties, modify the effects of an agreement or terminate it in part or in its entirety on the basis of unforeseen circumstances of such nature that the other party may not, according to the criteria of reasonableness and fairness, expect the agreement to be maintained in an unmodified form. The modification or termination may be given retroactive effect.
2. The modification or termination may not be pronounced to the extent that these circumstances are to be borne by the party relying upon them, according to the nature of the agreement or commercial common opinion.

The Dutch Civil Code provision is fairly liberal in its trigger for contractual modification, the criteria of “reasonableness and fairness” as to whether the contract should be performed in its unmodified form. Other European legal systems focus on the onerous nature of the performance, essentially the idea followed in the UNIDROIT Principles, that a contract has to be performed even if the performance becomes onerous, with the concept that there is such a thing as “excessive” onerousness, which is a ground for modification or excuse. This is the basic scheme

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<sup>22</sup> UNIDROIT Principles, Art. 6.2.1 (Contract to be Observed).

<sup>23</sup> UNIDROIT Principles, Art. 6.2.2 (Definition of Hardship).

<sup>24</sup> Article 258 of Book 6 of the Dutch Civil Code

of the Italian Civil Code provision, for instance, which explicitly adopts the concept (*eccessiva onerosità*)<sup>25</sup>.

It is worth citing the Brazilian Civil Code in this regard, since Brazil is a major investment destination for infrastructure finance and also has provisions of law inspired by the concept of “excessive” onerousness (*Onerosidade excessiva*).

**Article 478** : For contracts of continuing or deferred performance, if the performance by one of the parties becomes excessively onerous, providing an undue advantage to the other, and as a result of extraordinary and unforeseen events, the disadvantaged party may request the termination of the contract. The effects of a judgment of termination shall be retroactive to the date of the summons.

**Article 479**: Termination can be avoided if the defendant agrees to modify equitably the terms of the contract.

**Article 480**: If, in a contract, the obligations of performance apply only to one of the parties, such party may request that its obligations be reduced or modified as to its performance in order to avoid excessive burden.

Argentina has a similar provision, added to its laws in 1968. Its terms are cited below in Section IIA.

## II. QUESTIONS FOR INVESTORS AND LENDERS

Given the prevalence of the concept of hardship in most legal systems, particularly in countries that are importers of capital for infrastructure finance, many questions arise in the mind of equity investors and lenders alike. The following discussion is ordered along the lines of the issues that experience has shown to be of concern to developers and lenders and the legal elements to be considered.

### A. Will hardship be an excuse – clause or no clause?

As mentioned in the introduction, project contracts and concessions may or may not have hardship clauses in them. Often they contain various types of indexation, adjustment or stabilization clauses, but do not deal specifically with hardship. Almost always they contain some type of force majeure clause. While the two types of clauses overlap in their coverage, their application has different outcomes. If the conditions for force majeure are met, performance of the contract is suspended or excused, either partially or entirely, with the party affected bearing the economic consequences, unless there is a clause specifying otherwise. This

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<sup>25</sup> *Art. 1467 Contratto con prestazioni corrispettive - Nei contratti a esecuzione continuata o periodica ovvero a esecuzione differita, se la prestazione di una delle parti è divenuta eccessivamente onerosa per il verificarsi di avvenimenti straordinari e imprevedibili, la parte che deve tale prestazione può domandare la risoluzione del contratto, con gli effetti stabiliti dall'Art. 1458 (att. 168).  
La risoluzione non può essere domandata se la sopravvenuta onerosità rientra nell'alea normale del contratto. La parte contro la quale è domandata la risoluzione può evitarla offrendo di modificare equamente le condizioni del contratto (962, 1623, 1664, 1923).*

does not address the situation of whether the terms of a long-term contract could be altered under a hardship theory. In order to avoid unintended consequences by application of the law of the contract, both force majeure and hardship should be addressed, particular in large-scale investments where significant amounts of capital are employed.

If a contract is silent on hardship, the question is answered by reference to the law of the agreement. Most host countries have some sort of legal provision on adjustment for hardship, so the investor can expect that its contractual relations with its counterparty will be subject to these provisions. If a contract is silent, an attorney reviewing or drafting one of these agreements should carefully consider the applicable provisions of law on hardship in consultation with local counsel and, if possible, address issues of hardship in the contract. It is only in rare circumstances that these provisions of law are of mandatory application and cannot be adjusted by the parties. This follows a general principle prevalent in civil law countries that the contract is the law between the parties and the parties can agree to whatever provisions they choose, provided these do not violate mandatory provisions of law or public policy. As an example, one of the rare countries where the application and terms of the hardship statute cannot be altered is Algeria, and any agreement contrary to the terms of the statute is void.<sup>26</sup>

If a contract has a hardship clause, again an investor or financier must carefully consider its terms. If the trigger for the evocation of hardship is too liberal, it can be tightened. If the clause provides that adjustment must be “equitable” or “reasonable”, a stricter standard can be drafted – such as only those adjustments that are strictly necessary to address the temporary imbalance – or that no adjustment will be permitted that undermines the ability of the investor to service its debt obligations – or that a certain level of profitability will be preserved. These points are considered in more detail below.

#### *Importance of Adjustment Mechanisms in Contracts / Assumption of Risk*

Irrespective of whether there is or is not a hardship clause in a draft agreement, it is very important in any long-term contractual arrangement for there to be mechanisms to adjust to inflation, currency fluctuations and changes in law. Not only is this important in a general sense, these types of clauses can also serve as an example of how a contracting party has assumed the risk of an event. As the 4<sup>th</sup> exception to Art. 6.2.2 of the UNIDROIT Principles provides, a disadvantaged party cannot claim hardship if it has assumed the risk of an event.

A couple of recent examples are illustrative in this regard.

One relates to the dispute between an American investor, CMS Gas Transmission Company (“CMS Gas”) and the Argentine Republic. This dispute, which was submitted by CMS Gas to the International Centre for the Settlement of Investment Disputes (ICSID) pursuant to the terms of the US/Argentine Bilateral Investment Treaty, has resulted in a series of

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<sup>26</sup> Article 107(3) of the Civil Code: “When ... as a result of exceptional and unforeseeable events of general character, the performance of the contractual obligation, without becoming impossible, becomes exceptionally onerous in such a way as to threaten the debtor with exorbitant loss, the judge may, according to the circumstances, and after taking into consideration the interests of both parties, reduce to reasonable limits, the obligation that has become excessive. Any agreement to the contrary is void.

published awards on both jurisdiction and substantive questions of law. The award on the substance of the dispute was dispatched to the parties on May 12, 2005 and it is of interest because Argentina invoked the provisions of its civil code on hardship as one of the grounds for its lack of liability to CMS Gas for the effects of its emergency legislation, and there is a substantive discussion of the elements of hardship and its effects in the award.<sup>27</sup>

The investment in question was made in the context of Argentina's privatization of its natural gas transmission and distribution companies under laws passed in 1992.<sup>28</sup> Under those laws, the state gas company was divided into two transportation companies and eight distribution companies. One of the transportation companies was Transportadora de Gas del Norte (TGN). Investment in TGN was opened to private parties pursuant to a tender process. CMS Gas purchased a 25% interest in TGN in 1995 and later bought 4.42%, making its total equity investment just under 30%. CMS Gas' equity investment for the shares was \$175 million, a large portion of which was financed by loans in US Dollars. CMS Gas also claimed that TGN made more than \$1 billion of investments in the gas transport system since its initial investment.

Certain terms of TGN's license are at the heart of the dispute over the hardship claim. TGN's license had terms from a model license approved by decree, the key ones being that tariffs were to be calculated in dollars, conversion to pesos was to be effected at the time of billing and tariffs would be adjusted every six months in accordance with the U.S. Producer Price Index (PPI).<sup>29</sup> There was also supposed to be a general adjustment of tariffs every five years for the purpose of maintaining the real dollar value of the tariff.

Due to the worsening economic situation in Argentina, in late 1999 the Argentine Government sought the agreement of TGN and other gas companies to a deferral of the PPI adjustment. TGN agreed to an initial temporary adjustment for the first six months of 2000 and then another, with plans for the lost revenue to be recouped at defined times in the future. For reasons beyond the scope of this discussion, these agreements were not implemented and TGN's tariff was never adjusted to recoup the lost revenue. As the economic situation in Argentina evolved into crisis, the Government passed emergency decrees and laws in late 2001 and early 2002 which eliminated the rights of licensees of public utilities to calculate tariffs in US Dollars and to adjust tariffs per US PPI. As a result, all of TGN's tariffs were redenominated in pesos at a rate of one peso to one dollar. At the same time, the currency board pegging the Argentine Peso to the US Dollar was abolished and the Peso was devalued, initially down to 3 Pesos/Dollar from 1/1. The Emergency Law also envisioned a process of renegotiating tariffs, which resulted in renegotiated tariffs for some sectors by the end of 2004, but not in the gas sector.<sup>30</sup> CMS initiated a claim under the US/Argentina Bilateral Investment Treaty ("BIT") in July 2001 after the first US PPI recoupment was not made and amended its claim in 2002 to include an ancillary dispute as a result of the effect of the emergency measures.

<sup>27</sup> In the Proceeding between CMS Gas Transmission Company and the Argentine Republic, ICSID Case No. ARB/01/8 (May 12, 2005), referred to as the "CMS Gas Award".

<sup>28</sup> Law No. 24.076 of 1992 on the Privatization of the Gas Sector (the "Gas Law") and Decree No. 1738/92 on the Implementation of the Gas Law (the "Gas Decree")

<sup>29</sup> ¶¶54-58, CMS Gas Award.

<sup>30</sup> Citations to the various emergency measures and a summary of their effect on TGN may be found in ¶¶ 59-67 of the CMS Gas Award.

In its claims, CMS Gas asserted that it was unable to service its debt in US Dollars because of the devaluation of the peso, it taking more than three times as much revenue than before the measures to pay for each dollar of debt service, and that the value of its equity investment in TGN had dropped from \$261 million to \$17.5 million. Also, CMS Gas claimed that TGN's domestic tariff revenue had dropped by nearly 75% due to tariffs not being calculated in dollars and the lack of inflation (PPI) adjustments. These figures were disputed by the Argentine Government, which also asserted that TGN's operating costs had decreased because of the devaluation and that CMS Gas had over-leveraged its investment, contributing to its debt service problems. There is much discussion in the award on these points. For purposes of an analysis of the hardship theories here, it is enough to stipulate that the value of CMS Gas' investment was severely impaired. TGN and the Argentine Government had many discussions on adjusting the tariff regime, but they were not able to agree. For instance, TGN Gas asked for a series of tariff increases in 2003 which would have amounted to an overall 90% increase. In 2004, the Government was willing to consent to a 7% increase to take effect in 2005.

As mentioned above, Argentine law contains a statutory hardship provision, Article 1198 of the Civil Code, which provides that if the burden of one party in performing a contract becomes "excessively onerous", as a result of "extraordinary and unforeseeable events", that party can request that the contract be terminated, except if that party is itself responsible for the event. If the disadvantaged party requests termination, the other party may offer more "equitable" terms as a means to forestall termination."<sup>31</sup> In discussing this provision, the tribunal noted that the "theory of *imprevisión* was thus expressly introduced into the Argentine Civil Code."<sup>32</sup>

In discussing whether TGN's license should be adjusted, the Tribunal cited the various adjustment provisions of the License, e.g. (i) the denomination of the tariff in dollars, (ii) the adjustment of the tariff for inflation every 6 months and every five years, (iii) express provisions of the License that it would not be altered unless the written consent of the licensee were first obtained and that the tariffs would not be frozen or subject to price controls. Based on that, the Tribunal concluded that "if a rebalance of the contractual commitments was required because of changing economic circumstances and their effect on costs and returns, the mechanism to meet this objective were available under the law and the License."<sup>33</sup> The Tribunal found that the necessary adjustments could be accommodated within the structure of the guarantees offered to TGN and that, this approach "would have made any unilateral adjustment of the tariff by [the Government of Argentina] unnecessary."

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<sup>31</sup> The full text of the code section is as follows: *Los contratos deben celebrarse, interpretarse y ejecutarse de buena fe y de acuerdo con lo que verosíblemente las partes entendieron o pudieron entender, obrando con cuidado y previsión. En los contratos bilaterales conmutativos y en los unilaterales onerosos y conmutativos de ejecución diferida o continuada, si la prestación a cargo de una de las partes se tornara excesivamente onerosa, por acontecimientos extraordinarios e imprevisibles, la parte perjudicada podrá demandar la resolución del contrato. El mismo principio se aplicará a los contratos aleatorios cuando la excesiva onerosidad se produzca por causas extrañas al riesgo propio del contrato. En los contratos de ejecución continuada la resolución no alcanzará a los efectos ya cumplidos. No procederá la resolución, si el perjudicado hubiese obrado con culpa o estuviere en mora. La otra parte podrá impedir la resolución ofreciendo mejorar equitativamente los efectos del contrato.*

<sup>32</sup> CMS Gas Award, ¶222

<sup>33</sup> CMS Gas Award ¶238



Although the Tribunal did not say it in as many words, in emphasizing the inflation and other adjustment provisions of the License in rejecting Argentina's hardship argument, it was in fact endorsing the view that the risk of events was assumed by the Government, one of the exceptions to the applicability of hardship articulated in the UNIDROIT Principles<sup>34</sup>. In essence, the License was interpreted to mean that the Government of Argentina had assumed this risk.

In rejecting the hardship claim, the Tribunal also found that the events that had occurred in Argentina were foreseeable, meaning that the unforeseeability condition of the application of the doctrine was not met, as discussed in more detail below.

Recent disputes involving investment in the energy sector in Brazil also provide some interesting insights on the operation of hardship principles in practice. These disputes have not resulted in published arbitral awards, but certain aspects of them, including a claim of hardship by Petrobras, reached the courts in Rio de Janeiro with published decisions.

As is widely known, a high percentage of electricity generated in Brazil (over 80%) comes from hydroelectric sources. Starting in 2000, there was a serious drought in some areas of Brazil and the supply of power was severely constrained. In an attempt to address the shortage and to diversify its fuel sources, the Brazilian government put into place an emergency program to install thermoelectric power plants. A number of foreign companies made investments in the context of this program. The three largest ones were by El Paso Energy (Macaé – 928 MW), by a company called MPX Energia (Termoçeara – 224 MW), which was a consortium of MDU Resources, an American energy company based in North Dakota, and a Brazilian entrepreneur, and by Enron (Eletrobolt – 388 MW). These investments in power production were financed by revenue guaranty deals under which Petrobras, the state-controlled Brazilian energy company, agreed to cover the developers' cost of capital, operating costs and taxes in case the plants' power sales revenues were not sufficient.<sup>35</sup>

The series of agreements between Petrobras and the investors all had similar features. The main agreement was a contract to build a gas-fired power plant, with ancillary gas supply arrangements with companies that were largely affiliates of Petrobras. In addition, the investors and Petrobras agreed to a joint power marketing arrangement with negotiated profit sharing. If facility's revenues from power sales were not sufficient to cover costs, Petrobras would be obligated to make "contingency" payments for five years. In simpler terms, Petrobras essentially entered into a take-or-pay commitment to buy the power, while also supplying the gas needed for fuel. At the time the contracts were entered into, the spot market price for power, reflecting the drought-induced shortages, was R\$680/MWh. The prices under the contracts for the purchases were in the R\$100-200 MWh range. It was thought by the contracting parties that there could be significant profit in operating the plant if the spot market prices stayed above the contractual take-or-pay prices.

The contracts did not contain any hardship clause, but the joint marketing agreement did include a Force Majeure clause with a provision that in no event could Petrobras be relieved of

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<sup>34</sup> UNIDROIT Principles, Art. 6.2.2(4).

<sup>35</sup> *Petrobras Gives El Paso 30 more Days to Revise or Terminate Macaé Contract*, Platt's Global Power Report, Jan. 13, 2005, Latin America, p.8

its payment obligations. Brazilian law governed the contracts, with disputes to be resolved by arbitration, either in Rio de Janeiro under UNCITRAL rules with the American Arbitration Association as the appointing authority in the case of MPX and in New York under the auspices of the AAA's International Centre for Dispute Resolution in the case of El Paso. Interim relief could be obtained in the Courts of the City of Rio de Janeiro.

The plants in the emergency program were built more or less on schedule, but by the time they were completed the drought and its associated rationing had eased, meaning that there was, as a practical matter, no demand for the power from the plants. Electricity rationing imposed by the government of Brazil had greatly depressed the demand for power. There were also problems with the gas supply to the plants. The spot market price had dropped so far by the beginning of 2004 that Petrobras was obligated to make the contingency payments every month, beginning in January 2004.

In 2004, Petrobras announced that its power sector losses during the first nine months of 2004 were R\$ 962 million, out of total company-wide provisions of R\$1.48 billion (US\$ 455 million at then current exchange rates).<sup>36</sup> It also announced that its board of directors had resolved to buy controlling stakes in the plants concerned. Thereafter Petrobras pursued talks with the owners on the purchase of controlling stakes in the plant. It arrived at terms for Enron's Eletrobrás plant fairly quickly at a price of \$US189 million, as Enron was already bankrupt by this time and it was dealing with a consortium of creditors who had no equity in the deal.<sup>37</sup> As far as MPX was concerned, it asked for \$170 million for the interest, while Petrobras offered US\$127 million through a 15% discount on monthly payments until expiration of the contract in 2008<sup>38</sup>. Petrobras claimed at that time that its annual payments to Termo Ceará amounted to \$US 50 million, at the rate of \$5.4 million (R\$14 million) / month.<sup>39</sup> The parties could not agree and Petrobras became frustrated with the pace of the talks in late 2004.

In January 2005, when the spot market price for power in Brazil was \$R18/MWh, Petrobras did not make the R\$14 million contingent payment due and informed MPX that it had deposited that amount into escrow in a Rio de Janeiro court. At the same time, it stated that it wished to invoke the Agreement's arbitration provisions to decide the issue of hardship. Petrobras claimed that performance of the contract had become "excessively onerous" under Brazilian civil code provisions cited above and asked that the contract be revised or terminated. At that time, the court in Rio de Janeiro accepted the payment into escrow and MPX appealed the decision.

Petrobras did something similar for the \$20 million due to El Paso Energy for the Macaé plant. In that case, though, the same judge who had accepted the payment for MPX refused to allow the payment into escrow for Macaé. The judge issued a decision on Jan 28, 2005 in which she set out her reasoning for not accepting the payment into escrow. The reasoning is worth analyzing, because it contains a discussion of some of the key points on which a finding of hardship turns. In particular, the judge cited the force majeure clause of the contract to the effect

<sup>36</sup> *Petrobras May Seek Arbitration on Two Thermo Plants*, Dow Jones Newswires, Dec. 28, 2004

<sup>37</sup> *Petrobras Gives El Paso 30 more Days to Revise or Terminate Macaé Contract*, *op. cit.*

<sup>38</sup> *Petrobras Seeks Arbitration on Macaé, Termo Ceará Contracts*, Feb. 11, 2005, Business News Americas

<sup>39</sup> *Id.*

that in no event would Petrobras be relieved of making the contingency payments. In this respect, the judge, again without explicitly labeling it as such, appears to have adopted the fourth exception enumerated in Art. 6.2.2 of the UNIDROIT Principles, namely that Petrobras had in effect assumed the risk of the change in events. She also made arguments going to the foreseeability question and Petrobras' ability to absorb the risks, discussed below.

On February 2, 2005, the same judge reversed her January 12 decision on MPX, applying the same reasoning as the El Paso/Macaé decision. She also cites payment into escrow as a means of pressuring MPX on the sale of the plant.

Petrobras did not easily accept the judge's decisions in the two cases. Only two days later, it appealed the court decisions and, in public statements, reiterated its claims of hardship under Brazilian law.

"Brazilian legislation applied to the contracts allows for the possibility of a contractual revision, if unforeseen changes to the initially existing scenario occur .... Petrobras is acting strictly in line with the interests of its millions of shareholders that have been excessively burdened by the profits of its partner because the situation has changed drastically."<sup>40</sup>

It then announced on February 10, 2005 that it was going to invoke the arbitration clause of both the MPX and El Paso agreements and seek arbitration of the issue of whether there was hardship justifying a revision of the contract under Brazilian law. Its statement asserted that "[t]he legal order in Brazil does not force a company to abide by legal contracts where economic balance has been totally changed because of unpredictable facts."<sup>41</sup> On February 17, 2005, an appeals court turned down Petrobras' appeal of the Rio Central Court decisions. Additional judicial steps were taken by Petrobras, which apparently did not reach final resolution in view of the arbitral proceedings that were invoked.

Arbitral proceedings were initiated in both cases. The MPX case did not go forward because MPX was able to arrive at an agreement with Petrobras on the sale price of the Ceará plants (US\$137 million, including the US\$ 5 million in escrow)<sup>42</sup>. The transaction closed in June 2005<sup>43</sup>. Extensive negotiations were held in the El Paso case, but the parties nonetheless proceeded to arbitrate the question of whether Petrobras could legitimately invoke the Brazilian civil code provisions on hardship. In July 2005, the arbitral tribunal that was constituted issued an interim decision requiring Petrobras to make all contingency payments owing to date to El Paso (some \$R 227 million) against deposit of a bank guaranty by El Paso should the tribunal eventually rule in Petrobras' favor.<sup>44</sup> As of February 2006, the arbitration is still pending and no award has been published.<sup>45</sup> If the case proceeds to a final award and it is published, it will be of

<sup>40</sup> *Petrobras Clarifies Disagreements with MPX (Termoceara)*, Feb. 2, 2005, press release.

<sup>41</sup> *Petrobras' Position on the Merchant Thermoelectric Power Plants*, Feb. 11, 2005, press release

<sup>42</sup> *MDU Resources Announces Agreement to Sell Termoceara to Petrobras*, Mar. 24, 2005, [www.mdu.com/news](http://www.mdu.com/news)

<sup>43</sup> *Petrobras Seals Acquisition of Termoceara Thermal Generator*, June 17, 2005, Petrobras press release.

<sup>44</sup> *Macaé Merchant Power Plant: Petrobras & El Paso Arbitration Process*, July 8, 2005, Petrobras press release

<sup>45</sup> In November 2005 El Paso reported that the arbitration panel has "postponed" its final ruling on the dispute and that a final award would not be expected until sometime in the first half of 2006. *El Paso Corporation Reports Developments on Macaé Arbitration*, <http://investor.elpaso.com>, Nov. 30, 2005.

great interest since there are comparatively few published awards from international investment disputes that squarely address the question of hardship on the merits. On February 2, 2006, El Paso and Petrobras announced that they entered into a memorandum of understanding on the sale of El Paso's interest in the plant for \$358 million, sufficient to cover some \$255 million in project finance loans outstanding on the project,<sup>46</sup> thus apparently resolving their dispute, so it is not clear if a final award ever will be published.

Thus the lesson of the cases involving the emergency thermal plants in Brazil is clear. Whether or not the contract contains a hardship clause and, separate from the issue of force majeure, hardship will be an excuse under Brazilian law if the conditions are met.

### **B. The Unforeseeability of Events**

Almost all legal provisions adopting a hardship excuse for non-performance, and the UNCITRAL Principles, require that the event causing the alleged hardship be "unforeseeable". This then begs the question – what is foreseeable and what is not? This is in some ways almost a philosophical question, but one that is on the minds of investors and lenders. They wonder, "Isn't everything foreseeable in some sense?" The answer in a general sense is "yes", which is why in a long-term contract the first line of defense to preserve it is to have well-drafted adjustment or stabilization clauses that take into account changes over time in inflation, in exchange rates and legislation, among others.

In keeping with the general philosophical differences stated at the outset between common and civil law mindsets on contract risk, lawyers trained in the common law tradition that a contract allocates risk tend to take the observation to heart that everything is in a sense foreseeable – and also see it as something of a challenge to make sure that every eventuality is provided against in a contract. They sweat bullets and don't sleep at night worrying that they missed the one eventuality that will happen and be blamed.

Conversely, lawyers educated in the civil law tradition are trained to rely more on the provisions of law in the codes, which address fortuitous events and their consequences in a general sense. There is no need, in their minds, to spell out eventualities. The specific event giving rise to excused performance does not have to be unforeseeable, rather its occurrence.

Returning then to the basic question – what is foreseeable and what is not - there are a handful of recently published international arbitral awards that address in a specific way the element of unforeseeability in cases where hardship is claimed in international investment cases, including the award in *CMS Gas v. Argentina*, and in particular *Himpurna California Energy Ltd. (Bermuda) v PT (Persero) Perusahaan Listrik Negara (Indonesia)*<sup>47</sup>. Another useful source on the unforeseeability element is the considerable amount of commentary and jurisprudence on what is foreseeable or not in force majeure cases, both in international disputes and domestic court jurisprudence.

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<sup>46</sup> *El Paso and Petrobras Sign Memorandum of Understanding for Sale of Macae Power Plant*, Feb. 2, 2006, <http://investor.elpaso.com>

<sup>47</sup> Final Award of 4 May 1999, XXV Y.B. Int'l Comm. Arb. 13 (2000) - Referred to in this paper as the *Himpurna Award*.

In cases where hardship has been claimed the following circumstances have not been found to meet the criterion of unforeseeability (in other words, the following circumstances have been considered foreseeable):

- dramatic changes in market prices for products<sup>48</sup>;
- unfavorable general economic circumstances in a country;
- currency fluctuations, even severe;
- failure of a central bank to grant authorization to pay in foreign currency when foreign exchange control regulations were in place at the time of contracting; and
- armed hostilities between countries with a history of antagonism.

With regard to unfavorable general economic circumstances in a country, the award in the *Himpurna* case suggests strongly that the economic crisis in Indonesia beginning in 1997 was not unforeseeable. In that case, which did involve, among other things, a claim of hardship based on changed circumstances by a state-owned power company (known by its acronym PLN), the tribunal considered PLN's argument that its difficulties were "unprecedented". While acknowledging that this may be true for the company PLN, the tribunal pointed out that 1997 was certainly not the first time that Indonesia found itself in economic crisis, citing the example of 1966 where inflation reached 1,500 percent in a twelve-month period.<sup>49</sup> The tribunal found that when the parties entered into a long-term contract (30-year energy sales agreement), "there was no reason to assume that Indonesia would be insulated from a repetition of history." The tribunal also cited many other examples of countries in macroeconomic difficulty to support the finding that "[p]arties entering into international contracts cannot claim unawareness of the risks of macro-economic adversities ... their effects may be extreme, but are nonetheless *within the contemplation of the signatories*."<sup>50</sup>

Similarly, but without elaborate explanation, the tribunal in *CMS Gas v. Argentina* took the position that Argentina's difficulties were not unforeseeable. In particular, one of Argentina's arguments was that TGN's tariff should not be adjusted to neutralize the effects of inflation and currency value because the tariff should be understood to include both currency and country risks. The Tribunal turned this argument on its head, asserting that Argentina, by

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<sup>48</sup> In the ICC Award in Matter No. 2216 (1974), the case arose because a Norwegian company failed to perform a petroleum purchase agreement because the price of petroleum had gone down by more than half between the time of contract and scheduled delivery. The Tribunal did not permit an adjustment in the contract price on the basis of a hardship argument. This was not found to constitute a "bouleversement" of economic circumstances, but a simple fluctuation in market prices. In a commentary to this case by Yves Derains, then Secretary General of the ICC Court of Arbitration, he pointed out that to accept this type of fluctuation as a ground to exonerate the non-performance of a contract "would put in danger the security of transactions." Yves Derain, *Chronique des sentences arbitrales*, Clunet 1975, p. 921.

<sup>49</sup> *Himpurna Award*, ¶203.

<sup>50</sup> ¶207 (emphasis added)

making the argument, it was “simultaneously admitting that this risk was foreseeable and actually foreseen.”<sup>51</sup>

In the recent disputes between Petrobras and El Paso and MPX cited above, the judge of the Rio de Janeiro Central Court, in denying Petrobras’ request to have the court accept its contingency payments into escrow, noted that the contingency payment provisions of both the El Paso and the MPX contracts were virtually identical. This being the case, she wondered how Petrobras could later question them.<sup>52</sup> In this respect, she seemed to adopt a foreseeability approach. The clauses were not put in the contract by mistake, they were meant to address in fact the contingency that later happened – Petrobras not needing the power after the hydrology improved.

Indeed, it is difficult to find published arbitral awards from international investment disputes that take the position that the economic difficulties encountered by a country or one of its enterprises were not foreseeable. Consistent with this practice with respect to the El Paso arbitration, it would be hard to imagine that the arbitral tribunal could find that the downturn in the economic situation in Brazil was unforeseeable in the sense understood by international practitioners.

The commentary to Article 6.2.2 of the UNIDROIT Principles on hardship takes a somewhat less rigorous line on what is foreseeable and not. For instance, with respect to sudden currency devaluations, there an illustration of a sales contract between two parties in which the price is expressed in the currency of country X, a currency whose value was already depreciating slowly against other major currencies before the conclusion of the contract. A month later, a political crisis in country X leads to a massive devaluation of the currency on the order of 80%. A dramatic acceleration of the loss of value of the currency of country X was not foreseeable, according to the commentary.

The award rendered in ICC Case No. 8486 (1996) contains a discussion of whether a collapse in the market for a product is considered foreseeable or not. In that case, a contract between a Dutch supplier of manufacturing equipment and a Turkish buyer was in dispute. The contract was entered into in March 1992 and provided for Dutch law to govern. The Turkish buyer was in the business of selling sugar cubes and the equipment was in part to be specially manufactured by the Dutch seller to meet the Turkish buyer’s specifications. The particular payment terms of the contract were that the Buyer had to pay 5% of the sales price one year prior to delivery and had to open an irrevocable letter of credit in favor of Seller no later than two months prior to delivery. The Seller only was able to pay 3% of the sales price within the required time frame and could not open the letter of credit. The Turkish Buyer claimed that it was discharged of its obligations under the contract because of the “dramatic drop in price” of its product in the Turkish market, which amounted to hardship and claimed for the return of the 3% deposit it did pay.

The sole arbitrator in this case found that the conditions of this provision of Dutch law were not met. The Turkish defendant described the market conditions in detail in a fax, which

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<sup>51</sup> CMS Gas Award, ¶225.

<sup>52</sup> Decision of the Central Court of Rio de Janeiro, January 28, 2005.

included the introduction of private manufacturers, causing a fall in price of the product, and more general economic conditions in Turkey. The arbitrator considered that these elements were not unforeseeable and that the risk of the evolution of the market in Turkey had to be borne by the Buyer.

The arbitrator further cited writings on Dutch law and international commercial practice to the effect that the termination of a contract for unforeseen circumstances should be allowed only in "truly exceptional circumstances" and the ruling of a Dutch arbitral tribunal to the effect that a dramatic fall in the price [of a product] as well as currency fluctuations alone are not unforeseen circumstances and thus do not justify the termination of a contract.

In the ICC award described below in cases No. 3099 and 3100, the tribunal considered a claim of force majeure by an African state-owned buyer of petroleum products based on a refusal of its central bank to authorize payment in foreign currency. The tribunal found the element of unforeseeability lacking in this claim insofar as the foreign exchange regulations were already in force at the time the sales contract was entered into and it was not unforeseeable that the Central Bank would fail to grant an authorization under existing regulations.

This award is in line with many precedents of international arbitral jurisprudence where failure of a contracting party to obtain foreign currency for payment is not unforeseeable, especially when the exchange control regulations were in place at the time of contracting. See e.g. ICC Award in Matter No. 2216 (1974) where a Norwegian company failed to perform a petroleum purchase agreement because the price of petroleum had gone down by more than half between the time of contract and scheduled delivery. One of its defenses was that the Norwegian authorities opposed performance due to the loss of foreign currency this would have entailed. The tribunal found that this was not unforeseeable.

Regarding the question of armed hostilities between countries with a history of antagonism, in an ICC Award from 1971 (Case No. 1512), a Pakistani bank had agreed to guarantee to an Indian Cement Company that certain obligations of a supplier would be performed by promising to pay 94 Pakistani Rupees for every ton of cement due from the supplier but not delivered. The guarantee was governed by its terms by Indian law. An armed conflict between Pakistan and India arose in 1965 and lasted through 1966. During this period, Pakistan imposed an emergency legislation that considered as illegal any payment to an Indian party. None of the agreed deliveries for the years 1965, 1966 or 1967 were made and the Pakistani bank did not make payment under the guarantee. It raised both the English law doctrine of frustration of purpose and the more general principle of *rebus sic stantibus* (similar to the French doctrine of *imprévision* or hardship) as defenses. There was apparently no hardship clause in the guarantee. The sole arbitrator, Prof. Pierre Lalive, sitting in Geneva, rejected both the frustration and *rebus sic stantibus* arguments. With regard to the latter, he said:

The principle of *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* [emphasis in original] justify it, having regard not only to the fundamental character of the changes, but also to the particular type of contract involved, to the requirements of fairness and equity and to all circumstances of the case.

It should be obvious that none of the requirements which might justify the application of the 'doctrine' are fulfilled in this case. As a general rule, one should be particularly reluctant to accept it when there is no gap or lacuna in the contract and when the intent of the parties has been clearly expressed, as in the Bank Guarantee. Caution is especially called for, moreover, in international transactions where it is generally much less likely that the parties have been unaware of the risk of a remote contingency or unable to formulate it precisely.

This rather strict reading of the Pakistani bank's defenses was influenced no doubt by the parties' express choice of Indian law to govern the guarantee and the apparent lack of any illegality under Indian law with respect to the performance. The arbitrator also later in the decision rejected a force majeure argument on the grounds that the change in circumstances was not unforeseeable since, under general principles of law, the war was predictable.

The foregoing discussion concentrates on arbitral awards and court decisions where claims of hardship have been rejected. There are, however, some published arbitral awards in which hardship claims are accepted. One is *In the Matter of Arbitration Proceedings between Icori Estero S.p.A and Kuwait Foreign Trading Contracting & Investment Co.*<sup>53</sup> In that, an ad hoc tribunal acting under UNCITRAL Rules considered a contract entered into by an Italian construction company in 1985 with the government of Kuwait for the construction of a new Kuwait embassy in Algeria, in a contract governed by Algerian law. The currency of payment was U.S. Dollars. Algeria is one of the relatively few countries in the world that has a mandatory provision of law requiring adjustment to a contract in changed circumstances. Without going into the complicated facts of this case, suffice it to say that a majority of the three arbitrators accepted a depreciation in the value of the U.S. Dollar with respect to the Italian Lire of about 35% as a changed circumstance justifying compensation to the contractor when its costs were largely in Italian Lire. The award did contain a strong dissent by one of the arbitrators in which he objected to the interpretation of the scope of the depreciation in value of the Dollar as not meeting the type of extreme that even the wording of the Algerian Civil Code provision would suggest and also argued that the depreciation was not unforeseeable.

### C. What is Merely "Onerous" and "Excessively Onerous"?

Another conceptual question arises as to what is so onerous in international practice that it justifies a change in the terms of a contract, or its termination. Is there a fine line between what is merely "onerous", such that the disadvantaged party has to continue performing and bear the unfavorable economic consequences, and what is "excessively" onerous, which justifies an adjustment to the contract terms?

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<sup>53</sup> Published in 9 Int'l Arbitration Report, A-1 (1994).



Further, is the standard objective; in other words, does the same set of circumstances justify relief no matter who the disadvantaged party is? Or is it the standard subjective? Does the ability of the disadvantaged party to bear the loss matter in the analysis?

The UNIDROIT Principles (Article 6.2.1) start off the discussion of hardship with a statement that “[w]here the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations...”, but make this statement subject to the following article on hardship (Article 6.2.2), defining hardship as follows: “There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract ... “ and certain other conditions exist<sup>54</sup>.

The UNIDROIT Principles then establish the standard of hardship as a “fundamental” alteration of the equilibrium of the contract. In order to give some flavor as to what this means in practical terms, the commentary to this article states that if 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.” The commentary also gives some other illustrations of this principle. One illustration cited would allow renegotiation of a construction contract where an unexpected devaluation in the currency of the host country, whose currency is the currency of payment, causes the cost of the imported machinery to increase by more than 50%. In other illustrations, the following situations are said to constitute undue hardship:

- a ten-fold increase in price due to a post-contracting change in government regulation<sup>55</sup> and the imposition of new safety regulations after conclusion of a contract to build a plant requiring installation of additional equipment and “making [the contractor’s] performance substantially more onerous”;
- a sudden devaluation of a country’s currency (the currency of payment) on the order of 80%;
- the disappearance of a market for a contracted product (as opposed to a contraction in the market for a product)<sup>56</sup>

Other formulas in the commentary include “the limit of sacrifice”<sup>57</sup>, *une rigueur injuste* (undue hardship)<sup>58</sup>, changed circumstances to the point that in exchange for a party’s

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<sup>54</sup> These conditions are that: “(a) the events occur or become known to the disadvantaged 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.”

<sup>55</sup> In that situation a party generating waste entered into a four-year contract with a waste disposal company in a certain country. The price is fixed per ton over the term of the contract. Two years into the performance, the Government of the country prescribes prices for storing waste that are ten times higher than before.

<sup>56</sup> In that case, a dealer in electronic goods in the former East Germany contracted in September 1989 to buy inventory from a supplier in another former socialist bloc country. The goods were to be delivered in December 1990. In November 1990, the buyer in East Germany informed the seller that the goods were no longer of any use to it on the grounds that after unification with West Germany, there was no longer any market for the electronic products from the socialist country supplier.

performance the other party receives no performance in return,<sup>59</sup> or requiring a contracting party to “risk ruin” in continuing to perform<sup>60</sup>.

Some commentators go far to say that there is a general principle of international law to the effect that every commercial transaction is founded on the balance of reciprocal performance and to deny this principle would turn a commercial agreement into a type of gaming contract (*un contrat aléatoire*), or pure speculation.<sup>61</sup>

It should be emphasized that the commentary available tends to be more receptive to claims of hardship than arbitral tribunals and national courts are in actual disputes, as an analysis of published awards shows. There is a fair amount of commentary written by law professors or proponents of harmonization of national laws who find the concept of contractual balance theoretically appealing and promote the idea of adjustment by neutral parties to reflect changed circumstances in order to ensure the viability of long-term contracts. International business people and legal practitioners find this prospect much less appealing, of course.

In the 1999 arbitral award in the Himpurna case above, stemming from a failed Indonesian power project, the Indonesian state power company PLN made the claim that changed circumstances should require negotiations in good faith to reform the contract in a manner that reflects the changed circumstances. PLN cited in support of this argument a provision of the Indonesian Civil Code (Article 1338) requiring good faith in the performance of contracts. PLN’s counsel cited statistics, accepted by the tribunal, as to the scope of Indonesia’s financial collapse – a contraction of the Indonesian economy by 15% between 1998-1999, loss of 5 million jobs, 80% loss of value of the rupiah, inflation rate exceeding 75%. The tribunal was willing to accept that under Dutch as well as Indonesian law (based on the 19<sup>th</sup> century Dutch civil code), there are situations in which the rule of good faith may operate to dissolve or transform contractual rights and obligations, but that it is “quite clear that such a remedy is reserve for *extreme* cases” (emphasis added). The tribunal goes on to cite some Dutch

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<sup>57</sup> Michael Bonnell, *An International Restatement of Contract Law* (2d ed. 1997), at 130.

<sup>58</sup> Formulation from Bruno Oppetit, author of a classic treatise on French contract law - “a change in the initial assumptions with respect to which [the parties] committed themselves ... comes to modify the equilibrium of this contract to the point of making one of them suffer an unjust hardship.” (*une rigueur injuste*) *L’adaption des contrats internationaux aux changements de circonstances : la clause de hardship*, Clunet 1974, 794.

<sup>59</sup> Henry Lesguillons, *LAMY Contrats internationaux*, Paris, Lamy, juin 1995, division 4, art. 398. “*On admet que le principe pacta sunt servanda trouve lui-même sa limite dans le principe supérieur de la bonne foi. Or il est contraire à la bonne foi de maintenir les obligations imposés au débiteur par le contrat si les circonstances se sont modifiées au point qu’en échange de sa prestation cette partie ne recevra aucune contre-prestation ou seulement une prestation derisoire. On lui permettra donc de resoudre le contrat si l’autre partie n’accepte pas une solution équitable.*”

<sup>60</sup> J. L. Devolvé, another French commentator, has defined it as a situation characterized by the occurrence of exceptional, unforeseeable circumstances, external to the parties, that has on the equilibrium of the contract such an effect of bouleversement that the obligor, without being in a state of impossibility of performance, cannot do it without “risking ruin, or in any case considerable harm.” *L’imprévision dans les contrats internationaux*, COMITÉ FRANÇAIS DU DROIT INTERNATIONAL PRIVÉ, *Travaux du Comité français de droit international privé*, Paris, Edition du Centre national de la recherche scientifique, 1989-90.

<sup>61</sup> See e.g. the commentary of Yves Derain to the Award in ICC Case No. 2291 (1975) – “*toute transaction commerciale est fondée sur l’équilibre des prestations réciproques et ... nier ce principe reviendrait à faire du contrat commercial un contrat aléatoire, fondé sur la speculation ou le hasard.*”

authorities as examples: a Dutch supreme court case from 1926 in which a party was not excused because a fortuitous event had caused the price to rise by 75% and a 1931 case where the same court gave no relief to a plaintiff who had made a loan of 125,000 German marks only to find that its nominal value in Dutch guilders had become practically worthless as a result of the hyperinflation.<sup>62</sup> The tribunal concluded that the parties should not be directed to renegotiate the contract.

In the ICSID Award from CMS Gas v. Argentina, the Tribunal also cited some statistics with respect to the Argentine economic crisis - In 2001, there was a decline in Argentina's GDP of 4.4%. That decline was 10.9% in 2002. GDP rose again in 2003 and 2004, by 8.8% and 7.8%. Argentine inflation was 25.9%, 13.4% and 9.4% in 2002, 2003 and 2004, respectively. As discussed above, the Peso was devalued in 2001 and went from being pegged to the US Dollar at 1:1, to a low of 3.59/US Dollar. In 2004 and 2005, the Peso has fluctuated between 2.90 and 2.97 / US Dollar.<sup>63</sup> In sum, the Tribunal adopted the view that sometime between late 2004 and early 2005, the crisis period came to an end.<sup>64</sup> In characterizing the Argentine situation, the Tribunal stated:

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.<sup>65</sup>

There are several published ICC awards rejecting hardship claims where the question of the onerous nature of continued contract performance was addressed. In one fairly recent one,<sup>66</sup> the contract in dispute was a construction contract between an international consortium formed under French law and an Algerian entity for the construction of a road in Algeria. The contract named Spanish law as governing. The contractor was delayed in performance and was assessed liquidated damages. The contractor claimed in arbitration that the delays were due to force majeure and that it should not be liable for liquidated damages. It further claimed that its extra costs in performance should be compensated based on a theory of hardship. There was no explicit hardship clause, but the arbitrators cited Spanish case law to support a general right under Spanish law to claim contract adjustment due to changed economic circumstances. In the Spanish cases considered, the rule cited was that "the terms of a contract may be modified by the judge to reestablish the preceding equilibrium under the following conditions: (a) an extraordinary alteration of circumstances between the time of performance of the contract and its signing; (b) an exorbitant disproportion between the parties' performance which annuls the pre-existing equilibrium ... ; that this situation be caused by events that are patently unforeseeable." This citation is of interest because its terms are rather similar to the proposed revision to the PPA hardship clause.

<sup>62</sup> Cited in ¶188 of the Himpurna Award.

<sup>63</sup> Economic statistics cited in ¶¶ 442-448 of the CMS Gas Award.

<sup>64</sup> CMS Gas Award, ¶250.

<sup>65</sup> CMS Gas Award, ¶355.

<sup>66</sup> ICC Award in Case No. 8873 (1997)

The difficulties claimed by the Contractor were as follows: (i) general lack of security in Algeria created by attacks against foreigners, particularly French nationals; (ii) difficulties in doing business in Algeria, such as in sending materials, spare parts, recruiting of personnel etc.; (iii) transportation problems due to the degradation of the Algerian national road network and the periodic closing of roads; (iv) interruption in supplies of asphalt due to production shut-downs at Algerian supplier factories; (v) natural elements, including heavy rains and sand storms; and (vi) the defendant's alleged improper use of the road under construction, necessitating unforeseen repairs.

Without any elaborate explanation of their reasoning, the arbitrators rejected the contractor's claim for adjustment based on hardship. They found simply that the contractor's situation did not meet the definition of hardship under Spanish law.

This case also is interesting in that the tribunal did find, on the basis of the contract's force majeure clause, that two of the difficulties claimed did amount to force majeure – the closing of roads and asphalt supply problems. The tribunal found that the road issues justified 15 days of delay in performance and the asphalt supply problems 20 days. As a result, the contractor's obligation to pay liquidated damages was reduced by 35 days. This case then seems to stand for the proposition that contract adjustment based on hardship is more difficult to demonstrate than force majeure, particularly if the contract contains a clause defining force majeure events. It is also consistent with the general theory stated at the outset that a finding of force majeure can relieve a party of the performance of a duty, but it does not result in an adjustment to the contract terms, thus highlight the difference consequences of the two doctrines and how both should be addressed in international investment contracts.

In another ICC award, a contract between a seller of fuel and its buyer was in dispute.<sup>67</sup> The contract was governed by Swiss law, which did not have any statutory provision for adaptation of contract due to hardship. The Seller did not perform because it claimed that a tripling of world market petroleum prices since the time of contracting was an external economic circumstance that justified non-performance unless the contract were adapted. The Seller proposed a renegotiation of the price, but the parties could not agree. The arbitrators ruled that under Swiss law a change in economic circumstances external to the contract did not justify its non-performance. However, under the theory that the rule of Swiss law should not be so rigorously applied to international contracts, they considered the Seller's arguments. They then found that Seller failed to meet its burden of proof on the size of the increase in petroleum prices. First of all, the Seller refused to give a detailed account of its sources of supply and what would have been the supposed grave consequences to it of performing the contract, apparently out of concern for not revealing trade secrets. It merely relied on general market factors showing an increase in petroleum prices. Later, at the arbitration hearings, the Seller admitted that the prices had only increased 25-50%. From these facts, it is possible to state two principles: (1) in order for a party to prevail on a hardship claim, it must give a detailed justification of the impact upon

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<sup>67</sup> ICC Award in Case No. 2508 (1976) reported in 104 *Journal du Droit International*, No. 4 (Octobre-Novembre-December 1977), p. 939–

it and cannot rely merely on general economic circumstances and (2) an increase in price of 50% of fuel is not significant enough to justify non-performance.

Interestingly, since the Seller admitted that the contract in dispute represented only a small percentage of the Seller's revenues, the tribunal found that it unlikely that the performance of the contract at the agreed prices would have caused "unbearable difficulties" for the Seller's business. Therefore, it is possible to extract from this award another principle that a contract affected by a change in economic circumstances must represent a significant portion of a company's revenues for performance to be considered "unbearable". Other arbitral jurisprudence supports the theory that the standard for judging what is bearable is subjective. What is unbearable or "excessively onerous" for a relatively small company for which a particular contract represents a significant part of its revenues may be merely onerous and thus bearable for a large, well-funded company which does not risk serious financial difficulty as a result of continued performance of the contract.

If one were apply this principal to Petrobras in the disputes over the emergency thermoelectric plants discussed above, one would note that according to Petrobras' own financial reporting, its gas and power department, which was the one responsible for the management of the emergency power contracts, projected profits of \$R500 million (\$US186 million) as of the end of 2004, which was in part due to the renegotiation of other contracts similar to the three largest ones and also in part due to having bought stakes in gas generators to avoid the take-or-pay losses.<sup>68</sup> This reversed a loss in 2003 of \$R 1.6 billion for the gas and power department, which Petrobras blamed in significant part on the cost of power contracts it had with gas generators. The gas and power department is, of course, just part of Petrobras, which is a huge enterprise with a net income of over R\$17 billion in 2004 and the largest market capitalization in Brazil.<sup>69</sup> While Petrobras was no doubt losing money on the contingency contracts, one can hardly argue that it could not make the payments. Since the dispute with El Paso appears to have been resolved, practitioners will probably be deprived of the arbitral tribunal's views on the issue of whether the losses were "excessively onerous" under Brazilian law, which is unfortunate, because it would have made for interesting reading.

In any event, the judge of the Central Court of Rio de Janeiro hearing the request for interim measures filed by Petrobras, namely that it should be allowed to make the contingency payments into escrow, seems to have been swayed in January 2005 at least by the fact that continued contract performance didn't seem to pose any risk to Petrobras, which is a very profitable enterprise. This aspect of the judge's decision should be read to underscore the subjective nature of the hardship analysis. What may be excessively onerous for one party should not be for a company as large, well-financed and profitable as Petrobras.

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<sup>68</sup> *Petrobras Mulls Taking El Paso to Arbitration Court*, Dec. 20, 2004, Business News Americas

<sup>69</sup> See Form 6-K filed by Petrobras in March 2005 with financial statements for the years ending Dec. 31, 2004 and Dec. 31, 2003.

#### D. What is External to the Party Claiming Hardship?

The UNIDROIT principles and most national laws that recognize hardship require that the economic circumstances impeding performance be external to the party relying on them, i.e. that the contracting party is not itself responsible for them. An international arbitral tribunal cannot be expected to accept a hardship claim if the difficulties encountered by a contracting party were the result of its own act or negligence.

A difficult question arises when a contracting party is partially or entirely state-owned: Are acts of the State or of other agencies or instrumentalities of the State “external” to a state-owned enterprise? If they are, then a state enterprise could claim that acts of its own government are external to it, thus satisfying one of the usual criteria of a claim for hardship.

There are few (and no recent) international arbitral awards that deal explicitly with a claim of hardship by a state enterprise based on an act of the host-country government. There are, however, many awards that deal with claims of force majeure by state enterprises when the source of the event is an act or their own government – and the analysis as to externality should be the same.

One commentator has said flatly that if the “host country asserts a hardship or force majeure event which it brought about itself (legislation), it cannot rely on the clause even when the contract was not made with the state directly, but instead with a government corporation ...”.<sup>70</sup> He goes on to say that state owned enterprises are denied reliance on a contractual force majeure clause because, “in a similar fashion to piercing the corporate veil, they are regarded as an integral component of the state which is responsible for the change on conditions in the host country.”

An ICC award rendered on May 30, 1979 in cases No. 3099 and 3100 dealt with two contracts concluded in 1974 and 1975 between an Algerian state enterprise and a state enterprise of another African country. The contracts were for the sale of refined oil products and crude oil, governed by Algerian law. The Algerian seller delivered the products, but the buyer did not pay all of the invoices on time. The buyer admitted its liability for the principal amount of the unpaid invoices, but rejected the seller’s claims for interest on the basis of force majeure. The defendant claimed to have sufficient sums available to pay, but could not obtain the necessary authorization for payment in U.S. Dollars from the Central Bank of its country under relevant exchange control regulations. The contracts contained identical force majeure clauses, but the clauses did not contain a definition of force majeure. As a result, the tribunal relied on the classic definition of French law, which is an “unforeseeable and unavoidable event which comes from outside the person who invokes it.”<sup>71</sup> The tribunal cited a treatise on French civil law to the effect that force majeure is defined by its three characteristics: externality, unavoidability and unforeseeability.

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<sup>70</sup> Peter Berger, “Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators”, 36 *Vanderbilt Journal of Transnational Law* 1347, 1352 (Oct. 2003)

<sup>71</sup> Until 1975, Algerian law was still based on French law and the contracts were concluded before the transformation.

The tribunal considered whether the Central Bank's not making foreign currency timely available to the Buyer, a state enterprise, should be considered as an "external" event. The tribunal cited a decision of the French Court of Cassation dated April 15, 1970 which considered a claim by Air France, a state enterprise, that acts of its supervisory authority, the Ministry of Public Works, through the General Secretary of Civil Aviation, was the unforeseeable and insurmountable intervention of a third person justifying its non-performance of a contract with certain of its employees. The French Court rejected this argument, saying that the link between the State and the obligor prevents the intervention of the State from being considered an act of the sovereign that allows excuse from performance. The tribunal cited an opinion of the French solicitor general in that case, as follows:

"If the thesis of Air France were to be accepted, it would become much too easy for companies submitted to the supervision (*tutelle*) of the State to exonerate themselves from their obligations ... In fact, in relation to third parties, such a company and the State form one and the same legal entity; the intervention of the public authority, which is organically linked to the normal functioning of the company, does not constitute an outside event which can be invoked against third persons and contracting parties."

At the time of the decision in this case, 70% of the capital stock of Air France was held by the State. Eight of its 16 directors were named by the State.

There has been some useful commentary on the Air France case. In one article by Pierre Mayer, a French professor well-respected in international arbitration circles, he states that:

Even in the absence of a provision by the parties, their intent must reasonably be interpreted as rejecting the external nature of acts of those state organs which play an institutional role in the functioning of the state legal entity. Thus, when a state entity is subject to the supervision of a ministry, the intervention of the latter may be assimilated to an element of its own decision process, even if it is presented as being external. It is not a question of denying the distinction between the personality of the state and that of its agency, but simply to consider that one who contracts with a supervised entity is normally not ready to admit that the supervisory authority may discharge it of its obligations.<sup>72</sup>

This award in ICC Cases No. 3099 and 3100 and its reference to the decision of the French Court of Cassation form the most unequivocal statement in international arbitral jurisprudence of the lack of external character of a decision of a state with relation to its state enterprises. Other awards support it. I am aware of unpublished ICCs award from cases in which I have been involved in which the arbitrators rejected claims by state-owned petroleum enterprise that a decree of the minister of energy of that country, its supervisory ministry, which denied an import license for a product subject to a contract with a foreign private enterprise, was force majeure.

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<sup>72</sup> Pierre Mayer, *La neutralisation du pouvoir normatif de l'Etat en matière des contrats d'Etat*, 1986 Journal du droit international (Clunet) 5

In the dispute that was the subject of the Himpurna Award, which involved an Indonesian power project with a thirty-year energy sales agreement with PLN, an entirely state-owned power company, PLN also claimed force majeure based on presidential decrees from late 1997 and early 1998 suspending or canceling almost 70 independent power projects due to the financial and monetary crisis in Indonesia. In that case, a U.S. owned entity had entered into an energy sales contract in 1994 with PLN to build four geothermal units and sell the output for a period of 30 years to PLN. One of the units was commercial and one was finished at the time of the suspension decrees. In the award, the arbitrators examined PLN's enabling legislation, legal status and operational history. Its executive director testified at the hearings that PLN is an instrument of government policy and that its tariffs were set by the government. The tribunal also reviewed a presidential decree from later in 1998 which established a team for the "Restructuring and Rehabilitation of PLN. It was chaired by the Minister of State for Coordination of Development Supervision and Administrative Reform and contained six other ministers.<sup>73</sup> The tribunal concluded that: "[i]n the present case ... PLN cannot avoid liability by invoking State actions because the GOI and PLN cannot, in light of the legal framework which has given legal life to PLN and under which it operates, be characterized as separate." The tribunal also found decisive evidence that in the particular circumstances of its case, PLN "entirely subordinated its will to the GOI."<sup>74</sup> It should also be noted that there was a provision in the energy sales contract that, with respect to the investor only, an act of a governmental authority would be force majeure, which the tribunal interpreted as an explicit assumption by PLN of risk of government actions.

There are, however, contrary precedents. In several cases regarding foreign trading enterprises of former Soviet-bloc countries, arbitral tribunals found that these enterprises had independent legal personality and that a decision of a state organism could constitute force majeure for a public enterprise. See e.g. ICC Award in Matter No. 2478 (1974) where the arbitral tribunal, considering a contract governed by French law, stated that the revocation by the Romanian government of an export license granted to a state enterprise would constitute force majeure under general principles of international law.<sup>75</sup> The English House of Lords, in a widely publicized decision, found that a Polish state-owned exporter of sugar could rely on the revocation of its export license by the Polish government to justify the non-performance of its contractual obligations. In that case, the Polish government cancelled the export license due to a poor sugarbeet harvest, which had left the export trading company unable to full its contractual obligations.<sup>76</sup> The House of Lords reasoned that:

State-controlled enterprises, with legal personality, ability to trade and to enter into contracts of private law, though wholly subject to the control of the state, are a well-known feature of the modern commercial scene. The distinction between them, and their

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<sup>73</sup> They were the (i) State Minister for Revitalization of State-Owned Enterprises, (ii) the Minister of Mining and Energy, (iii) the Minister of Finance, (iv) the State Minister for National Development Planning, (v) the State Minister for Research and Technology and (vi) the Minister of Trade.

<sup>74</sup> Himpurna Award, ¶89

<sup>75</sup> Award of July 3, 1958 of the Arbitration Commission for Foreign Commerce of the USSR emphasizing the separate legal personality of the enterprise, 53 A.J.I.L. 800 (1959)

<sup>76</sup> *Czarnikow Ltd. V. Centrala Handlu Zagrancicznego "Rolimpex"* (1978) 2 ALL E.R. 1043.



governing state, may appear artificial, but it is an accepted distinction in the law of England and other states.

A German commentator and prominent international arbitrator, Professor Karl-Heinz Böckstiegel, has acknowledged that the questions of “whether and under what circumstances state enterprises may excuse non-fulfillment of contractual obligations by claiming force majeure due to acts of public authority by their own state” is a disputed one, but says that “the starting point will have to be the principle that the separation between the state enterprise and the state is respected and that therefore normally acts of public authority by the state have to be accepted as an excusing case of force majeure.”<sup>77</sup>

In French administrative law, the theory of adaptation of the contract due to changed circumstances (*imprévision*) must apply, at least to the benefit of private companies contracting with the state, in the interests of the continuity of a public service.<sup>78</sup> One French commentator has stated that the unforeseen circumstances may result from measures by a public entity other than the one that is party to the contract (contrary to the theory of *fait du prince* or sovereign compulsion in force majeure cases). For example, a law or decree having an impact on the performance of contracts with state entities by means of price regulation or prohibition of the use of certain products or suspending certain imports can be seen to be unforeseen circumstances in administrative law contracts.<sup>79</sup> This position is thought to be protective of private parties in their contracts with state entities.

Another French commentator, Yves Derains, has approached the subject in the same way as one would approach a claim to pierce the corporate veil of a subsidiary of a private company. According to Derains, who was then the Secretary General of the ICC Court of Arbitration, the independence of a public enterprise with respect to the State, just like the independence of a subsidiary with respect to its parent company, must be assessed as a factual question.<sup>80</sup>

In the *Himpurna Award* and in other arbitral jurisprudence, the arbitrators were very much swayed by specific allocations of the risk of fortuitous events, including contract clauses to the effect that the acts of the host-country government cannot be considered force majeure by state-owned contracting parties.

In sum, it should be a rare case indeed in which a state-owned or controlled enterprise should be able to prevail on a theory that the act of its own government, which gives rise to economic difficulties on the part of the state enterprise, should then serve as excuses for non-performance or grounds for adjusting contracts validly entered into with foreign investors.

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<sup>77</sup> *Arbitration and State Enterprises* at 46 (1984).

<sup>78</sup> Emmanuel S. Darankoum, *L'application des Principes d'UNIDROIT par les arbitres internationaux et par les juges étatiques*, 36 R.J.T. 421, 469 (2002)

<sup>79</sup> R. Chapus, *Droit Administratif général : éd Montchrestien 2002, 14e éd., no 1383.*

<sup>80</sup> See Y. Derains, *Chronique des sentences arbitrales*, in 107 *Journal du Droit International*, No. 4, (1980), p. 958.

### E. What Happens When One Party Claims It is Suffering Hardship?

Another perplexing aspect of the hardship debate is more a procedural one. How does a disadvantaged party bring up the subject of hardship? If it lets things get to the point where performance really is unbearable, it will no longer be able to perform, almost by definition. Presumably it will raise the issue of hardship at some point before it can no longer perform and request an adjustment to the contract terms. Even so, can it stop performing at that point? Can it only partially perform? If it claims hardship, when does the existence of the hardship or not come into dispute?

#### *Claim for Termination of the Agreement or Request for Negotiations?*

Most of the national hardship statutes inspired by the concept of “excessive onerousness” require the disadvantaged party to actually claim for the termination of the agreement. The Brazilian statute is explicit in this regard. Only then can the unaffected party offer an adjustment to the terms of the contract to preserve its viability.

The UNIDROIT Principles take a different approach. Article 6.3.3 allows that, in the case of hardship, the disadvantaged party is entitled to request renegotiations. However, the request for renegotiation does not entitle the disadvantaged party to withhold performance. If the parties can’t agree on an adjustment to the contract within a “reasonable” time, either party may resort to a court. Then it is up to the court to either terminate the contract at a date and on terms to be fixed or adapt the contract with a view to restoring its equilibrium.

In the case of the dispute involving CMS Gas and Argentina, CMS Gas made the argument that the hardship Civil Code provision was inapplicable because the concept requires the aggrieved party to request the termination before a competent court, while in that dispute the changes in the License term were unilaterally decided by one party.<sup>81</sup> This argument had some influence on the Tribunal, which found that the adjustment terms of the License allowed a rebalancing of the contract for economic circumstances. “This approach, in turn, would have made any unilateral determination by the [Government of Argentina] unnecessary.”<sup>82</sup>

In the disputes involving Petrobras and El Paso Energy and MPX, Petrobras took an interesting tack in view of the applicable legislation, the Brazilian Civil Code provisions on hardship,<sup>83</sup> and the dispute resolution mechanisms of the contracts (arbitration under UNCITRAL Rules in Rio de Janeiro). Instead of making the contingency payments to the project owners, it proposed to deposit the money into escrow with the Central Court of Rio de Janeiro and to commence an arbitration to determine if the excuse of hardship was indeed a valid one under the circumstances. While this showed a certain respect for the dispute resolution mechanisms of the contract, as compared to simply withholding payment, it still served to deprive the projects of funds. The Central Court of Rio de Janeiro at first accepted the logic of the escrow, but then came to reject the approach in its decision of January 28, 2005. The judge, in her decision, anticipated the substantive hardship arguments that Petrobras might make and

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<sup>81</sup> CMS Award, ¶225.

<sup>82</sup> CMS Award, ¶238.

<sup>83</sup> Articles 478-480, cited above

indicated that she did not think they had merit – namely that Petrobras had borne the risk of what happened by explicit contract provisions. Also, as mentioned above in the discussion of what is “excessively” onerous, the judge was also very much swayed by the fact that continued contract performance didn’t seem to pose any risk to Petrobras, which is a very profitable enterprise. So, ironically, it appears under this reasoning that Petrobras’ ability to make the payments into escrow served to highlight that the burden it had to bear was merely onerous, not “excessively onerous”.

In any case, as a practical matter, a party who feels disadvantaged by events will invariably raise the issue with its contracting partner and seek a negotiated settlement well before it is to the point of being unable to pay. Then, it is up to that partner to assess whether, in the light of the national law or international arbitral jurisprudence, whether the claim of the disadvantaged party would in fact amount to hardship in a formal sense. This assessment plays into the parties’ negotiating positions. Whether or how the adjustments are made may well depend on external or political factors, but the discussion at least is held by reference to the legal framework and whether the disadvantaged party has a good case or not. This underscores the importance, then, of practitioners being aware of the law of hardship that pertains in the jurisdiction to whose laws an investment contract is subject and seeking in the negotiation process to either neutralize the effect of the statutory hardship provisions or to define the parameters of when hardship can be invoked and what the consequences will be.

*The Obligations to Negotiate in Good Faith and to Exercise Efforts to Overcome the Effect of Changed Circumstances*

In legal systems where hardship is recognized, once a party claims it is disadvantaged, the other party cannot simply dismiss the claim. It should be understood to have a duty to negotiate in good faith. If the claim for hardship has a legitimate basis, refusal to negotiate can be construed to that parties disadvantage. There is an interesting French domestic court case, where a contracting party was found liable for damages and interest on a theory of good faith because it refused to allow a revision of the terms of a contract which led the other party “to ruin.”<sup>84</sup>

The Commentary to Article 6.2.3 of the UNIDROIT Principles states that during the renegotiation process, both parties are subject to the general principle of good faith and the duty of cooperation. Thus, the “disadvantaged party must honestly believe that a case of hardship actually exists and not request renegotiations as a purely tactical maneuver.” The Commentary goes on to say that “both parties must conduct the negotiation in a constructive manner, in particular by refraining from any form of obstruction and by providing all the necessary information.”

Under French law, the analysis begins with the basic principle in Article 1134 of the Civil Code that contracts must be performed in good faith. In one French court decision interpreting a hardship clause, the Paris Court of Appeal held that a hardship clause “obliges the parties to renegotiate the contract in good faith.”<sup>85</sup> One decision of the French Court of Cassation

<sup>84</sup> Cass. Com., 3 nov. 1992 : Bull. civ. IV, no 338.

<sup>85</sup> CA Paris, 28 sept. 1976 : JCP G 1976 II, 18810, note J. Robert

considers the situation where the conditions for adjusting the contract have been met and an obligation to renegotiate is put upon the parties. In this case, the parties must negotiate and present "serious offers" failing which their liability will be established.<sup>86</sup> Nonetheless, there is no obligation in French law for the negotiations to be successful. In the absence of a clause specifying the consequences, a failure of the negotiation results in a requirement to maintain performance of the contract in all of its terms. This is why, according to the scholarship, it is important in contracts to provide what the consequence of a failed negotiation should be: either termination of the agreement or reference to a third party (an arbitrator or a court) to make a determination of the proper adjustment to the contract. This is the common practice under French law. In the first instance then, the neutral third party will rule on the existence of the hardship, then on whether the contract should be adapted to the circumstances.

Incidentally, under French law, as interpreted by an ICC arbitral tribunal, the party not claiming hardship is also bound by an obligation of good faith to renegotiate the contract as well when in fact the economics of the contract are upset. The tribunal found it to be abusive that the obligee refused to undertake any steps to arrive at an adaptation of the contract and insisted on performance as it was originally provided in the contract.

Commentary on French law has recognized that it is difficult to demonstrate a violation of the obligation to carry out discussions in good faith. A breach does not simply result from the fact that the agreement is not made. It must be demonstrated that a party, by its behavior, compromised the progress of the negotiation in order to cause its failure. It is up to the judge or the arbitrator to determine if the behavior complained of constitutes misconduct or not by reference to the standard of a reasonable person (*bon père de famille*).<sup>87</sup>

On the other hand, the disadvantaged party cannot simply throw up its hands in the face of the adverse circumstances. It must be able to demonstrate that it has exercised its efforts to overcome the effects of the fortuitous events or risk having negative inferences drawn against it later. One Swiss commentator, Prof. Pierre Lalive, in an article dealing with the principle of good faith in the performance of contracts with state enterprises, has cited international law and arbitral practice for the proposition that the general obligation to perform contracts in good faith requires the disadvantaged party to "minimize" the damage that might result from its non-performance of the contract.<sup>88</sup>

Prof. Lalive cites one arbitral award in an ad hoc arbitration arising from the cancellation by the revolutionary government of Iran of a contract between Iranian state agencies and a French company entered into by the Shah's government for the purpose of developing nuclear power facilities in Iran.<sup>89</sup> In that case, the Tribunal said that it would "like to stress" that, even independently of the specific clauses of the contract:

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<sup>86</sup> (Cass. Soc. 24 mars 1958 : J.C.P. 58, II, 10868).

<sup>87</sup> JurisClasseur, Contrats, Fasc. 20 : POURPARLERS – 2 – Obligations conventionnelles de négocier ; d) Régime des obligations de négocier, ¶ 47.

<sup>88</sup> Pierre Lalive, *Sur la bonne foi dans l'exécution des contrats d'état*, 425, 449 in *Mélanges offerts à Raymond Vander Elst* (Editions Nemesis 1986) Tôme I

<sup>89</sup> *Framatome v. AEOI*, reported partially in *Clunet*, 1984, 58.

[E]ach contracting party who is temporarily prevented from performing its contractual obligations has the general duty of good faith to make efforts to that end.

Prof. Bockstiegel has written that when a state-enterprise is seeking to assert a governmental decision as an event of force majeure, this claim should be rejected first of all in the obvious case where the state enterprise has sought the decision to avoid its obligations, but also in the case where the state enterprise has omitted to use the means at its disposal to obtain the rescission or annulment of the decision.<sup>90</sup>

It is interesting to note, in addition, that the ICC recently published sample Force Majeure and Hardship Clauses.<sup>91</sup> In this sample hardship clause, when a party proves that the continuation of its contractual duties has become “excessively onerous” due to an event beyond its reasonable control “which it could not have reasonably have been expected to have taken into account at the time of the conclusion of the contract” and that “it could not reasonably have avoided or overcome the event or its consequences”, the parties are bound to negotiate alternative contractual terms “which reasonably allow for the consequences of the event.”

The fact that the ICC drafting commission found it important to specify that no hardship could be claimed if the affected party could not have overcome the event or its consequences also tends to suggest that this obligation to overcome is an element of the analysis in international commercial practice of whether the disadvantaged party is entitled to relief.

The Tribunal in the CMS Gas Award affirmed this general principle:

The Government has the duty to redress this abnormal situation, first, by putting an end to what by definition should be a temporary situation, a step that might be adequately taken in the context of the continuing negotiations between the parties, and next by paying compensation for the damage caused.<sup>92</sup>

#### *Adjustment by Court or Arbitral Tribunal*

If, in spite of good faith negotiations and the disadvantaged party’s efforts to overcome the effects of the situation, the parties cannot reach agreement on adjustments, in some jurisdictions with statutory hardship provisions, the disadvantaged party can apply to a court for a determination on the appropriate adjustments, rather than seek termination of the agreement. In international infrastructure investment, where the parties agree to resolve disputes by international arbitration, in theory arbitral tribunals can play this role as well.

The award in the CMS Gas v Argentina case is of particular interest in this regard. In the award, the arbitral tribunal asserts its own authority to fix compensation since the parties could not agree.

<sup>90</sup> *Soixante ans après – Regard sur l’avenir* (ICC Publishing 1984), p. 46

<sup>91</sup> ICC Force Majeure Clause 2003; ICC Hardship Clause 2003 – Developed by the ICC Commission on Commercial Law and Practice – Draftsman-in-chief: Professor Charles Debattista (ICC Publishing Feb. 2003)

<sup>92</sup> CMS Award, ¶245

Similar to what was the case in the *Gaz de Bordeaux*, since the parties have as yet been unable to reach an agreement through the process of contract renegotiation, compensation is to be fixed by a judge. As this Tribunal has no judge to whom the case could be remanded for that purpose, it will fix the compensation to that effect on its own authority.<sup>93</sup>

This is an interesting precedent indeed in international arbitral jurisprudence, since it involves a business operation that is ongoing. TGN has not ceased operations and CMS Gas is still an investor. On this theory, the Tribunal could have actually set the proper adjustment to the License so that the balance of the License is restored. In the actual case, it chose to grant relief to CMS Gas more like compensation for an expropriation, which was due to its finding that Argentina had breached the “fair and equitable treatment” standard of the US/Argentina BIT. This was also due in part to the offer of CMS Gas to turn in its shares upon payment of compensation.

#### F. If a Contract is Adjusted, What is the Standard for Adjusting It?

Under Article 6.2.3 of the UNIDROIT principles, if hardship is found, a court may readapt the contract “with a view to restoring its equilibrium.” The commentary to this article says that when a contract is adapted with a view towards restoring its equilibrium, the court will seek to make a “fair distribution of the losses between the parties”.<sup>94</sup> The commentary goes on to say that this may or may not, depending on the nature of the hardship, involve a price adaptation. If it does, the adaptation will not necessarily “reflect in full the loss entailed by the change in circumstances” since the court will have to consider the extent to which one of the parties has taken a risk and the extent to which the party entitled to receive performance may still benefit from that performance.

Without any explicit statement of it, in practice what the Tribunal did in the CMS Award follows the logic of the fair distribution of losses stated in the UNIDROIT Principles. In spite of its rejection of the hardship claim, the Tribunal in the CMS Gas Award did include language in the award suggesting that Argentina should not entirely assume the economic consequences of the License’s adjustment procedures. For instance, it stated at one point of the award that:

“[t]he question for the Tribunal is then how does one weigh the significance of a legal guarantee in the context of a collapsing economic situation. It is certainly not an option to ignore the guarantee, as the Respondent has advocated and done, but neither is it an option to disregard the economic reality which underpinned the operation of the industry.”<sup>95</sup>

At a later stage in the award, it noted that “while in the instant dispute the conditions for the operation of the *théorie de l'imprévision* are not met ... the fact is that the Claimant cannot

<sup>93</sup> CMS Award, ¶246

<sup>94</sup> See also, Emmanuel S. Darankoum, *L'application des Principes d'UNIDROIT par les arbitres internationaux et par les juges étatiques*, 36 R.J.T. 421, 473 (2002)

<sup>95</sup> CMS Gas Award ¶165.

ask to be entirely beyond the reach of the abnormal conditions prompted by the crisis, as this would be unrealistic.”<sup>96</sup>

If CMS Gas’ arguments had been accepted on tariff adjustment, namely that the contract’s adjustment mechanism should have been allowed to work, it would have been entitled to at least a 300% increase in tariff, on the theory that that Peso went from par to the US Dollar to 3:1, not to mention the several years of inflation adjustments it had to forego. Again, when discussing the economic crisis in Argentina, the Tribunal takes pains to say that its effects must be taken into account.

The factual situation ... allows the Tribunal to take into account different situations present at distinct period in time. The crisis had itself a severe impact on the Claimant’s business, but this impact must to some extent be attributed to the business risk the Claimant took on when investing in Argentina, this being particularly the case as it relates to decrease in demand. Such effects cannot be ignored as if business had continued as usual. Otherwise, both parties would not be sharing some of the costs of the crisis in a reasonable manner and the decision could eventually amount to an insurance policy against business risk, an outcome that, as [the Government of Argentina] has rightly argument, would not be justified. On the other hand, a number of the measures adopted did indeed contribute to such hardship and the burden of those ought not to be placed on [CMS Gas] alone.<sup>97</sup>

While the Tribunal, in its rulings on the technical hardship arguments seems to take a fairly strict approach, namely that the adjustment mechanisms of the contract ought to be applied, it also seems by this language more or less to adopt the notion that the outcome of a legitimate claim of hardship is some sort of reasonable sharing of the costs involved. The paragraph quoted comes rather close to a “split-the-baby” conclusion.

What is somewhat curious about the award is that it is unclear how the assertion about sharing of costs finds its way into the relief granted to CMS. Unfortunately for a pure analysis of the hardship questions, the relief granted is more akin to compensation for expropriation since, as mentioned above, the Tribunal found that Argentina had violated the “fair and equitable treatment” standard of the US/Argentina BIT. As a result, the compensation ordered of \$133.2 million is in a lump sum to take into account the decline in value of CMS Gas’ equity investment. Further, the Tribunal has given Argentina the option to purchase the shares if it pays the compensation and an additional \$2.148 million. However, if Argentina does so, it may deduct the sum of \$5.295 million in consideration of dividends received by CMS Gas in the period after August 17, 2000.<sup>98</sup>

In the remedies section of the Award, the Tribunal discusses the various methods of valuing equity interests in companies whose shares are not quoted on an exchange and, in the absence of guidance from the terms of the US/Argentina BIT, settles on the discounted cash flow

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<sup>96</sup> CMS Gas Award, ¶244.

<sup>97</sup> CMS Gas Award, ¶248.

<sup>98</sup> CMS Gas Award, ¶469.

method to determine the fair market value of CMS Gas' equity interest.<sup>99</sup> The sharing of costs concept mentioned in its earlier pronouncements does not really come up in the relief discussion. However, the "compromise" nature of the award becomes apparent in the way in which the Tribunal accepts or does not various assumptions used in the valuation proposals submitted. In particular, the Tribunal starts with TGN's own internal projections in 2000 using two different scenarios – "no regulatory change" and "with pesification."

The Tribunal takes into account the effects of the crisis in 2001 and 2002 by rejecting an assumption in the projections that demand for gas would have remained stable during those years. Since no study on the price elasticity of demand was produced by the parties, the Tribunal concluded that "it is reasonable to assume that sales revenues would have decreased by 5% in each of 2002 and 2003 and by 1% in 2004, reflecting the delayed impact of the declines in Argentine GDP of 4.4% and 10.9% in 2001 and 2002, respectively, somewhat mitigated by TGN's maintenance of export revenues in US Dollars."<sup>100</sup> Then, given the turnaround, the Tribunal takes the view that a gradual increase in demand would occur until capacity in the pipelines is reached, thus forecasting increases in sales through 2011.

Another indication of how the pain is shared by the Tribunal's use of assumptions is by no accepting the aspects of a report from a valuation expert on revenue and tariff adjustments. Under the "no pesification" scenario, the expert assumed an average yearly rate of revenue increase to TGN of 2.5% to 2007 and 1.5% thereafter to the original end of the term. The Tribunal did not accept those assumptions on the grounds that they would have led to a 20% rate of return in 2012, increasing to almost a 100% rate of return in 2027, at the end of the term of the License. As a result, the Tribunal decided to "introduce a 5% decrease in tariffs at the time of each of the tariff reviews in 2013, 2018 and 2023."<sup>101</sup>

So, in sum, CMS Gas claimed \$261 million in compensation if the Government of Argentina takes its shares in TGN and \$243 million if it didn't – and the Tribunal awarded \$133 million on the basis of the valuation assumptions it adopted.

In ICC Award in matter No. 2508 (1976), discussed above, where a Seller claimed that a tripling of the world market price of petroleum amounted to hardship, there is a discussion of the contract renegotiation dynamic. The Seller's proposals to increase the contract price tended toward increasing it to reflect world petroleum market prices. In other words, the Seller would have been almost fully covered against petroleum price increases. The Tribunal did not see this as fair. The Seller's requests, "consistent with good faith" had to be limited to not only what was reasonable, but also "to that what was strictly necessary so that performance of the contract did not become manifestly unfair." This aspect of the award supports the more general principle that when an adjustment of the contract is granted, the adjustment should not be designed to make the injured party whole, but only what was strictly necessary to make the performance bearable.

In one French case where a refiner had undertaken to sell fuel oil to Electricité de France (EDF), the parties had included a hardship clause that specified that an increase in the price of

<sup>99</sup> CMS Gas Award, ¶412

<sup>100</sup> CMS Award, ¶446.

<sup>101</sup> CMS Award, ¶456.



fuel oil greater than 6 Francs per ton over the price at the time of contracting would allow renegotiation. Prices of fuel oil increased in such a way that the seller invoked the hardship clause. An attempt at renegotiation failed and the supplier sued. The Court's direction in that case was that the parties had to substitute a price formula that would grant a reduced purchase price to EDF while allowing a "sufficient profit margin" to the refiner.<sup>102</sup>

Under French law, if an arbitration clause allows the arbitrator or tribunal to act in equity (as an *amiable compositeur*), the power to moderate the rights created by the contract, to avoid the consequences of the strict application of contractual clauses "without however modifying the economics of the agreement" is recognized. A prominent French law professor has written that the standard that should be used to arrive at a revision to a contract whose equilibrium has been disturbed is to re-establish the "equilibrium of reciprocal performance."<sup>103104</sup>

As the foregoing examples show, various adjustment standards are used in international arbitration and French law, summarized as follows from the most generous to the disadvantaged party to the least:

- adjustment of the contract to "eliminate the cause of the hardship" (based on a contractual clause containing those terms);
- alternative contractual terms "which reasonably allow for the consequences of the event." (ICC standard hardship clause);
- a re-establishment of the contractual equilibrium;
- "fair distribution of the losses between the parties" (UNCITRAL Principles)
- granting a reduced purchase price to the buyer while allowing a "sufficient profit margin" to the seller;
- Avoiding the consequences of the strict application of contractual clauses "without however modifying the economics of the agreement";
- "what was strictly necessary so that performance of the contract did not become manifestly unfair"

If an attorney is representing an investor or a lender, it can draw from this array of formulae to adapt the contract drafting to the situation, to make the scope of the adjustment as strict as possible. The converse is true if one is representing a host state or recipient of foreign investment. One could draft the hardship clause to make its adjustment standard be fairly liberal. If one is representing a lender, there is no reason why a reference to maintaining in all cases the ability of the project owner to make debt service could not be inserted. Equity has its own

<sup>102</sup> Paris 1re ch. 28 sept. 1976 : J.C.P. 78, ed. C.I., II, 18810, note J. Robert.

<sup>103</sup> "l'équilibre des prestations réciproques" – B. Goldman, *La lex mercatoria dans les contrats et l'arbitrage international, réalité et perspectives*, p. 495.

<sup>104</sup> Paris 6 mai 1988; Rev. arb. 1989, 82, note E. Loquin.

interests to protect as well, which would argue for formulae such as maintaining some defined profit margin or the “economics” of the contract in a larger sense.

One other point to note is that a review of some published sample hardship clauses shows that they sometimes provide that the adjustment will not in any case have any retroactive effect.<sup>105</sup> Nothing in the literature suggests that retroactive adjustments are an accepted way of dealing with contract imbalances and all of the commentary and cases examined by us to date deal with forward-looking adjustments to overcome changed economic circumstances. The theory is that the adjustments such as to tariffs and the term of the agreement will be applied over time to make up for the losses suffered during the temporary period of hardship.

### **G. If a Contract is Terminated, What are the Economic Consequences?**

If a contract is terminated for hardship and the parties have not specified the consequences of termination in their agreement, the termination indemnity will be left to the determination of a judge or an arbitral tribunal. Again, the relief section of the CMS Award is very interesting in this regard. The Tribunal found that CMS Gas was entitled to compensation for the reduced value in its shareholding. It then took the parties’ submissions and expert reports on what the value of CMS Gas’ shareholding should be and concluded that the discounted cash flow method should be used. A number of assumptions were inherent in these valuation claims, such as the likely duration of the contract, whether it is extended or not, inflation over the projected term, demand factors, economic growth in the market and many others, as well as interest and discount rates. Basically, what the Tribunal did was evaluate all the assumptions in the various sources and decide which ones it found reasonable and which ones it needed to adjust itself.<sup>106</sup> It makes for fascinating reading, although the term to be applied might be “horrifying” from the point of view of the investor, who is left to the mercy of an arbitral tribunal in deciding what is reasonable or not to assume in assessing losses.

One way to avoid this type of exercise is for the parties to negotiate termination payments at the time the agreement is entered into. Many long term investment contracts do contain termination payment provisions, with the more sophisticated ones having different payments for different scenarios – the breach of one party, termination for force majeure or hardship and a “no-fault” termination. Further, it is common in sophisticated project financings to provide that the termination payment must in all cases cover the service of the debt to the project lenders.

If the parties negotiate the termination payment, they can at least relieve some of the uncertainty associated with what the remedy might be for a successful claim of hardship and the investor may assure itself, at least insofar as contractual mechanisms can accomplish this, that their capital and return on capital assumptions will be established in the event of a dispute later.

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<sup>105</sup> See e.g. Ghana/Shell clause, cited in Klaus Peter Berger, “Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators”, 36 Vanderbilt Journal of Transnational Law 1347 (Oct. 2003)

<sup>106</sup> CMS Award, ¶430-467.

### III. DRAFTING CONSIDERATIONS

Given all the variables that go into mix when a party to an international investment agreement claims that changed circumstances entitle it to an adjustment of the contract terms, some consideration should be given to the extent to which drafters of contracts can address the potential consequences of these types of claims and provide for greater certainty in the performance of long-term contracts. After all, in terms of raising finance for investment in infrastructure, which is a goal that both investors and host countries share, the greater the chances that the parties' expectations will be realized, the easier it will be to raise the financing.

The following considerations are offered in this regard, with an acknowledgment that they contain a certain bias in favor of protecting a foreign private investor against the actions of the host state or its enterprises. Taken in the light of the development of the theory of hardship, there is a certain irony in this, since the genesis of the modern theory is a case where a private investor is found to be entitled to an adjustment of a contract vis-à-vis the state. Indeed, the theory under French law was meant and is still intended to be protective of private investors dealing with state enterprises. Unfortunately, though, today, practically all disputes arising from claims in changed circumstances are the result of a host country state enterprise seeking to avoid their original contractual obligations. The theories of absolute sovereignty over natural resources and state control of public services have waned over time, but many host countries and their enterprises still tend to take the view that when investors seek to do business in their country, they necessarily assume the risk of unforeseen events that might occur in that country – and if they are ultimately unwilling to do so, they should not do business in that country. While these drafting considerations are intended to neutralize that attitude to some extent, it is also submitted that providing a stable investment environment is beneficial for the host country and that it is in the interest of states and their enterprises as well to provide for predictable contractual adjustment mechanisms that minimize the adverse impact upon foreign private investors.

#### *Defining the Standards for Invoking Hardship*

As suggested at the outset of this article, since in most jurisdictions the statutory provisions on hardship are not of public order, the parties to an investment agreement are at some liberty to fashion a clause that suits them. For international investors and lenders, it is important from a due diligence standpoint to determine what the hardship laws say in a particular jurisdiction and examine how courts have interpreted them. If the standards appear reasonable, one option would be to have the contract be silent on hardship and let the applicable legal principles prevail.

If the standards are too liberal (the Dutch law, for instance, is quite liberal on the triggers for adjustment), then nothing prevents the parties from defining stricter ones both as to the triggers for hardship and the standards for adjusting the contract, unless the governing law does not allow derogation from the hardship provision. It is also possible to include less conventional clauses, such as a requirement that the disadvantaged party exercise its efforts to overcome the source of the hardship and, if the contracting party is a state enterprise, that that party cannot claim the acts of its own government as a source of a hardship claim.

Often times a hardship clause appears in the documents provided by host countries or other contracting parties. If this is the case, the clause has to be analyzed as to the triggers for claims of hardship and standards for adjustment. Again, these clauses can be adapted in the light of international practice to better suit the parties' needs.

### *Standards for Adjusting Long-Term Contracts*

In a larger sense, it is extremely important in dealing with long-term contractual arrangements to have clear adjustment standards to take into account the effects of inflation, currency fluctuations and changes in law. This is the standard practice in international investment agreements and few investors would enter into an agreement without indexation and stabilization clauses. From a due diligence point of view, attention must be focused on these clauses to ensure that they are clear and likely to work in an efficacious manner. And, as pointed out in the discussion above, these adjustment and stabilization clauses are the first bulwark in the defense against claims to adjust the contract due to hardship. If there is an explicit assumption of the economic risk of fortuitous events, most legal systems recognize that hardship adjustment claims are not permissible.

### *Obligations to Negotiate Contractual Modifications*

Another drafting approach for dealing with the issue of hardship would be to require that the parties negotiate in good faith to arrive at an adjustment of the contract according to the standards defined in the clause if in fact the conditions for a claim of hardship are met. In most common law jurisdictions, it is axiomatic that "agreements to agree" are not enforceable, so attorneys trained in these systems tend to view these clauses with some suspicion, even though the law has evolved in such a way that an agreement to negotiate in good faith is enforceable, even if it does not in the end require that the result be reached. The parties can be obligated to negotiate in good faith, but not to reach a result, so a dispute and the damages from breach would turn on a determination of the good faith of the parties. Most civil law jurisdictions have provisions requiring parties to perform contracts in good faith, which by definition imposes the exercise of good faith during a required negotiation. As suggested earlier in this article, the principle of good faith in contract performance has been interpreted in some circumstances to require reaching an accommodation when hardship is claimed. Usually, state enterprises from countries with hardship statutes assert some variant of this argument in disputes – that the strict application of contract terms is not in good faith if it causes extreme economic consequences for the other parties. International arbitrators, however, tend to be very reluctant to accept arguments like this due to the vagueness of the principles invoked.

One article addressing how courts in England address hardship clauses sets out some very practical considerations that can apply across a variety of legal systems and contracting situations.<sup>107</sup> Courts and arbitral tribunals are more likely to enforce agreements to agree if:

- (i) the circumstances allow the implication that, in default of agreement, a reasonable solution was intended, (ii) a formula is provided by reference to which

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<sup>107</sup> Adrian Montague, *Hardship Clauses*, INTERNATIONAL BUSINESS LAWYER (March 1985), p. 135

any absence of agreement can be resolved, or (iii) if, even in the absence of such a formula, the parties have provided adequate machinery to resolve their disagreement.<sup>108</sup>

Therefore, if the parties choose to deal with the issue of changed circumstances over time by inserting a contractual requirement to negotiate an adjustment, the chances of this type of agreement being enforced depend on the extent to which a court or arbitral tribunal views the parties' intention – did they intend to be bound over time?

### *Third Party Adjudication / Dispute Boards*

Another approach that is followed in international investment agreements is to draft in a provision where an arbitrator or some third party expert can be appointed to determine an adjustment question if the parties cannot agree. The parameters of the determination need to be clear, as well as how this special form of adjudication to deal with changed circumstances and contractual adjustment works in conjunction with the overall dispute resolution mechanism in the contract.

The use of permanent dispute boards as a third party adjudication mechanism has gained steady currency over the years, especially in construction contracts. If there is an adjustment standard in the contract in the event of hardship, a dispute board can in the first instance determine fairly quickly if the hardship triggers are met under applicable law and then proceed to apply the appropriate contractual adjustment formula. The parties are at liberty to provide in their agreement as to whether the determination of the dispute board will be advisory or mandatory. This is the approach taken in the recently published ICC Dispute Board Rules.<sup>109</sup> Either advisory or mandatory determination can be understood as promoting long-term contractual stability. If the determination of a dispute board is advisory, it provides the parties with reasoned guidance as to how they can adjust their agreement and continue to perform, albeit with the parties having to accept that guidance. If the determination is mandatory, the parties are bound to accept it.

A full discussion of what appointing a dispute board entails is beyond the scope of this article, but it should be noted that not all investors favor them. Many feel that they would like to control the negotiation process should a dispute arise and ultimately the decision to commence arbitration if an agreement cannot be worked out. The intervention of third parties in this process introduces an element of unpredictability. Further, dispute board clauses and the applicable rules chosen must be scrutinized to determine if the dispute board must follow the applicable law of the contract or whether the dispute board has the prerogative to make equitable determinations. There is no right or wrong answer to this, although it can be said fairly that international investors and lenders tend to disfavor the equitable approach and are inclined to accept dispute boards only if they are required to follow the law of the contract in their determinations.

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<sup>108</sup> *Id.* at 137.

<sup>109</sup> ICC Dispute Board Rules

### *The Balancing Act*

In sum, drafters of contracts must walk a fine line in addressing how the parties must respond to unexpected changes in circumstances in performance. Some level of precision is required in defining the circumstances under which claims of hardship can be invoked and what happens after that, but an attempt to address too many or all the consequences of the expected in contracts is a very hazardous exercise, as one author has very correctly pointed out.<sup>110</sup> If the drafting is over-detailed, it may backfire. By prescribing specific consequences for one event, it could be inferred that the parties did not intend the same consequences to apply to other events. On the other hand, wording that is too-open ended about the parties' obligation to negotiate in good faith and agree on how the costs of unforeseen events should be allocated among is bound to fail because the persons seeking to resolve the dispute, whether courts, arbitrators, experts or dispute boards, won't have enough guidance to make a decision.

### *Importance of Termination Provisions*

It is considered good practice in international investment to provide for defined termination payments. These termination payments can differ depending on the cause of the termination (fault of a party, force majeure/hardship and neutral) and can be sculpted by financial advisors to ensure payment of debt service, a return on equity invested and a return of capital, depending on the circumstances of termination. A well-considered termination provision can also serve as a bulwark against frivolous claims of hardship. If the consequence of a successful claim of hardship is termination, as the hardship statutes of many jurisdictions provide, and a defined termination payment must be made in this event, at least the parties know going in what the ultimate consequence of hardship will be. This type of provision should be enforceable in most jurisdictions under an "assumption of economic risk" type of analysis. If the parties know what the consequences of hardship will be, this can greatly influence the way in which they approach the negotiation of adjustments to the contract.

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<sup>110</sup> David Mildon, *Agreements to Agree: Does Expert Determination Provide a Default Solution?* (unpublished manuscript – November 2005)