Quality knows *no borders*

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Can We Get out of a Contract Gone Bad?
– International Outlook –

Pacta sunt servanda: contracts must be performed. This is the most fundamental tenet of the law of obligations. In this two-part series, we examine Hungarian and international law in terms of the opportunities they offer for getting released from a contract that has become financially untenable due to a change in the circumstances. We discussed solutions for this problem under Hungarian law in our first article, and now we will look at how the problem is addressed by French, German and common law.

This article examines how certain continental and common law systems deal with changes in economic circumstances. Although we find different doctrines and regulations, the fundamental principles are often similar, which can help in understanding Hungarian cases.

Common law systems

[1] Common law systems recognise situations where the performance of a contract is rendered impossible or represents an undue burden. A large body of case law in the United States deals with (commercial) impracticability, which means a situation where the performance of a contract has become unfeasible or, well, impractical. This doctrine is used when the transaction is no longer economically reasonable due to a change in the circumstances of the contract.

[2] **In the United States,** impracticability is – quite atypically for common law systems – codified. The Uniform Commercial Code (UCC), which serves to harmonise the laws of the states, includes rules pertaining to this matter.

According to these rules, a delay in performance or non-performance does not qualify as a breach of contract if performance is made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was based. The doctrine is applicable if the change in the relevant circumstance was not foreseeable or planned by the parties; the party seeking exemption did not assume the risk of non-performance either directly or indirectly; and it did not cause the change in the relevant circumstance. The examples cited for such contingencies include the severe shortage of raw materials or of supplies due to a contingency such as war, embargo or the unforeseen shutdown of major sources of supply.

[3] However, impracticability does not necessarily mean absolute impossibility of the performance. In exceptional cases, performance is considered unfeasible or economically unreasonable if the change in the circumstances imposes undue hardship on the party required to perform. On the other hand, a drastic change in costs will only serve as grounds for the application of the impracticability doctrine if it is a result of an unforeseen event. Construction contracts are generally based on flat-rate arrangements where changes in costs are always a sticking point, because the parties agree on a fixed price precisely to assume the risks associated with cost level fluctuations. The developer assumes the risk of cost reductions, while the contractor the risk of cost increases. Regardless of how prices change, one of the parties will have to bear the consequences. There were cases where the courts held that commercial impracticability even applied to flat-rate contracts, but this required at least a twofold increase in costs.

[4] In *Mineral Park Land Co. v. Howard*, the contractor was excused from the performance of their duties on the grounds of economic unfeasibility, even though complete performance of the contract was physically possible. The subject matter of the flat-rate contract was the mining and purchase of gravel located on the developer's land, for use in the construction of a bridge. However, the contractor only removed half of the agreed quantity, because it was found that the rest was under water, and the technology to mine it would have caused the costs to balloon to 10-12 times more than what the parties calculated when they signed the contract. In *Aluminium Co. of America (ALCOA) v. Essex Group, Inc.,* the court held that excessive inflation of energy prices was sufficient grounds for the plaintiff to be excused from its obligations. However, courts later refused to treat *ALCOA* as a precedent.

[5] For example, they did not rule that commercial impracticability applied when there was a 50% price increase on the steel market in the early 2000s. The court stated that not a price increase, but the unforeseeable event that caused the price increase in the first place should be used as defence in order for a party to be released from its obligations. The fact that steel prices increased does not in itself qualify as reason to excuse non-performance, particularly in view of the fact that price volatility on the steel market was always known to be high.

[6] **English law** addresses the impossibility of performance and the undue hardship that performance would place on a party under the umbrella term of

frustration. English courts must interpret the doctrine of hardship narrowly and apply it strictly if the nature of performance is radically changed.

[7] In *Krell v Henry*, Henry rented a flat with a good view to watch the coronation of Edward VII. However, the royal family postponed the coronation. While the obligations could have been performed, since Henry could still rent the rooms, the basis for the contract was no longer there due to the postponement. The court ruled that although performance was not rendered impossible, the basis of the contract ceased to exist and the contract was no longer binding the parties and therefore the law excused the parties from their duties and gave them an opportunity to terminate or modify their contract.

[8] Courts can find for a party on the basis of the hardship doctrine only in exceptional cases, when the goal of the contract has become unequivocally unachievable. Additionally we must note that English courts do not have the power to modify contracts, they can only terminate them. The common law approach holds that since parties can make arrangements for unforeseeable events in their contracts, they have to bear the risks of not doing so. Therefore, it is common for contracts to include hardship clauses in order to mitigate the strict rules of judicial practice.

German law

[9] The 2002 introduction of *Wegfall der Geschäftsgrundlage* (loss of business basis or interest) to German law, which is the closest system of law to Hungarian civil law, meant the codification of judicial practice going back to almost 100 years.

[10] If there are material changes in the circumstances serving as the basis for a contract and the parties would not have concluded the contract or would have concluded it with different terms in the knowledge of such change, the contract may be altered if one of the parties cannot be reasonably expected to honour – in the changed circumstances – the unaltered contract in the light of the totality of the circumstances, and in particularly, the contractual or statutory sharing of risks. These rules are also applicable to contracts where the parties were mistaken about a material circumstance.

[11] According to this doctrine, parties also have the right to rescind/terminate the contract if alteration is not possible or it is not reasonable for one of the parties. While German law also respects the *pacta sunt servanda* doctrine, it recognises that there are situations where the circumstances change so much that performance at any cost is not a reasonable solution even if it is actually possible.

[12] In order to have a better understanding of *Wegfall der Geschäftsgrundlage*, it is important to define what *Geschäftsgrundlage* (business basis) means. This term is understood to mean a circumstance that at least one of the parties assumed to be in place when the contract was signed, that was so important for that party that it would not have entered into the contract without it or would have done so with different terms if it had realised that the correctness

of its assumption had been questionable, and that the other party should reasonably have taken into account.

[13] The first court ruling on the existence of *Wegfall der Geschäftsgrundlage* was issued as a result of the hyperinflation that followed World War I. The relevant judgments held that due to runaway prices, the relevant contracts had lost their business basis and their renegotiation before a court was ordered. The courts had to try to make sure that the contracts were modified rather than rescinded.

[14] The *Reichsgericht* also adopted a similar judgment at this time. In the case, a landlord leased a piece of land to a tenant from 1894 up to 1922. Under German law, supplies located on a piece of land are considered to be a constituent part of the land and are treated in the same manner, meaning that they are returned to the landlord along with the land at the end of the lease. The tenant demanded the payment of the balance of the original value of the supplies and their value at the time when the land was returned to the landlord. As a result of the collapse of the German currency, the balance was nearly impossible to assess. Therefore, the court's primary objective was to strike an equitable balance between the parties' interests. The contract and the parties' contractual will was evaluated in the light of pre-war economic conditions. The judgment states that the quantity of the supplies did not change. Consequently, the court found that the landlord could not be compelled to pay a disproportionately high price simply because of the runaway inflation, as the actual value of the supplies only increased by 2%. This was the added value that served as the basis for the landlord's obligation. Therefore, he did not have to pay for the hyperinflation, but only for the actual added value.

[15] The *Wegfall der Geschäftsgrundlage* doctrine was also used in a case following the Berlin blockade. The buyer, a West German company, ordered certain products from the seller. The products were to be used in the Soviet-occupied Eastern zone, and the seller was aware of this. However, the Soviet Union blocked road and rail access to East Berlin after the order was placed but before the products could be delivered. The seller manufactured a batch of the products, issued its invoice and would have delivered the products to the buyer. However, the buyer did not take delivery of the shipment and did not pay for its order on the grounds that the reason for its contract ceased to exist due to the blockade and its unforeseeable length. The doctrine of *Wegfall der Geschäftsgrundlage* was examined by the court in terms of whether it could be applied in a case where performance was rendered more onerous to an indeterminable extent after the conclusion of the underlying contract. The court finally ruled in the light of both parties' rightful interests that the defendant was required to pay the expenses associated with the manufacturing of the outstanding products, determined to be 1/4 of the amount stated in the contract *expressis verbis*.

[16] In a 1992 case, the parties were privatised companies from East Germany. The contract between them concerned the importation of certain mining equipment, and the price was agreed in East German marks. Under the contract, the buyer would have paid half of the price from state aid, and the other half from loans. The state aid was even included in East Germany's budget, but then German reunification and monetary union happened. As a result, the buyer could not obtain state aid or loan financing to pay the price. The court ruled that the defendant could not claim financial hardship on the basis of the

absence of loan financing, but the non-payment of the state aid was a circumstance that was a determining factor in the existence of a valid business basis for the contract, and both parties signed the contract under the assumption that the aid would be granted. Therefore, the business basis of the contract ceased to exist due to the impossibility of obtaining the state aid. With the loss of the state aid, which accounted for 50% of the total financing required, performance of the contract at the original price represented an unforeseeable burden for the buyer. Pursuant to the principle of good faith dealing, such a burden could not be imposed on the buyer. Therefore, the court held that the buyer was entitled to a price reduction.

French law

[17] French law traditionally used to apply a strict approach to the judicial modification of contracts. An often cited judgement is the *Canal de Craponne*, a case from 1876. The relevant contract concerned the maintenance of a canal and was signed in the middle of the 16th century. It was binding for more than 300 years, and therefore the original fee had naturally lost most of its value to inflation over the centuries. Nevertheless, the court held that it could not modify the contract even though it had become disproportionately burdensome for one of the parties, considering the sanctity of the contract to be inviolable. The same approach was upheld by a judgment in 1921, which held that there was no legitimate reason for a court to modify a contract. As opposed to their German counterparts, French courts did not even believe that the 500% inflation that followed World War I qualified as a legitimate enough reason. In the meantime, however, there was a divergence in the treatment of administrative (concession) contracts and commercial law contracts.

[18] On the basis of a 1916 *Conseil d'etat* resolution, judicial contract modification became part of the case law of concession contracts. If, due to a change in the circumstances that could not be foreseen before an obligation fell due and that was beyond the parties' control. one of the parties faces difficulties in performing the obligation to such an extent that it would be unfair to demand performance from it, the court can modify or nullify the contract at such party's request. According to this doctrine, demanding performance in accordance with the original terms is only justified if the circumstances that existed on the date when the underlying long-term contract was signed do not change before the date of performance. The doctrine of *pacta sunt servanda* only applies if the circumstances do not change materially.

[19] Finally, the legal institution also gained clear recognition in commercial law with the 2016 modification of the *Code Civil*, which introduced an approach to contract modifications similar to that applied in Germany. However, the parties are required to renegotiate the terms of their contract to find a solution to the problem or to terminate the contract. Courts can also modify or terminate contracts if the parties are unable to reach an agreement.

Conclusion

[20] The various systems of law reviewed above approach unbalanced contracts in different ways. English courts apply a very strict approach, while in Germany consistent judicial practice that evolved over time led to the codification of a

more lenient interpretation that forms the basis of continental law systems. As the first article in our series shows, the Hungarian solution largely follows the German model.

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