A CHANGE OF CIRCUMSTANCES - GARRIGUES

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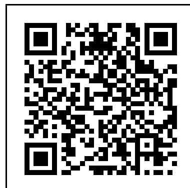

Various players in the M&A market (which includes financial investors, lawyers and advisers) and many companies that entered into contracts in times of splendour have been seeking, since the downturn of the economy, an exit from contracts or the release of their obligations under such agreements based on what is known as the “material adverse change” clause or the “rebus sic stantibus” principle, as it is traditionally known (and studied) in continental Europe.

Under Spanish law, unlike others in Europe, the Courts have established that the rebus sic stantibus clause is not recognised in law, although it finds a certain amount of legal support in the Spanish Civil Code and has been applied under the principles of equity. The fundamental premises for its application are therefore strict.

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The purpose of this article is to provider the reader with a general approach to such principle, to some of its highlights in comparative law, and, more specifically, to the way it is applied in practice by the Spanish courts.

Definition

Rebus sic stantibus omnis contractus intellegitur (all contracts are binding unless there is a change of circumstances): this Latin phrase summarises the principle of law that the circumstances taken into account when a contract was made and which determined the financial terms of the transaction may change after the contract is concluded, causing a material change that could give rise to the modification of its clauses.

This principle is seen as a way to bring flexibility to the *pacta sunt servanda* principle of law (contained in article 1091 of the Spanish Civil Code: "obligations that arise under contracts have the force of law between the contracting parties, and must be fulfilled according to the contract"), to avoid very unfavorable or over costly effects for one of the contracting parties.

Historic precedents

Based on Seneca, Saint Thomas developed this idea in his *Summa Theologiae* as the justification for breaking a promise that was intended to be fulfilled after the circumstances have changed. It was later treated, among others, by Samuel Puffendorf and included subsequently in the Prussian Civil Code in 1794, in relation to the provisions on termination of contract due to a change of circumstances. In Spain, it was treated mainly by Federico de Castro in his doctrine on the legal transaction (and "purpose"). In the United Kingdom, its primary precedent is in the *Coronation Case*: a balcony was rented to watch the coronation procession; but the procession did not take place.

Legal common sense dictates that the contract should no longer bind the parties, but the problem is to find the grounds that would make the contract invalid and, at the same time, determine the essential characteristics on the basis of which to establish in a specific case whether it is a change of the circumstances that gave rise to the contract or an individual motive without consequence.

Doctrine

There are no specific provisions in this respect in the Spanish Civil Code, the reason being the legal certainty, pursued by the coding ideal of the nineteenth century, which was given shape in article 1091 of the Civil Code, mentioned above. Legal commentators and the courts, however, have dealt with the possibility of building the *rebus sic stantibus* clause into current Spanish law as a means of establishing fairly the balance between obligations changed by supervening circumstances.

It is considered that the clause can be pleaded even if it has not been stipulated, for which legal support is found in article 1258 of the Spanish Civil Code, according to which "contracts are perfected by mere consent, and from that time bind the parties not only to the fulfillment of what has been expressly stipulated, *but also to all of the consequences which, according to their nature, conform to good faith, usage, and the law.*"

The limited scope in article 3 of the Civil Code must also be taken into account (in relation to the interpretation of contracts and the limit on equity), along with *force majeure* (1105) and the doctrine of error in consent (article 1265 and article 1266 of the Civil Code).

Some elements of comparative law

This problem is not confined to Spanish law. Until the recent reform of the BGB (German Civil Code), German law also treated this problem with a concept developed in the doctrine and case law called "basis of the business" or "*Geschäftsgrundlage*".

Since it was codified in the BGB article 313 (entitled "Alteration of the basis of the business", under subtitle 3, "Adaptation and termination of contracts") it establishes that:

(1) If, following the conclusion of the contract, the circumstances that have become the basis of the contract have changed and, if such a change was foreseen, the parties did not conclude the contract or concluded the contract with other terms, the parties can require an adaptation to the contract to the extent that a party cannot be required to keep the contract unchanged, by reference to all of the circumstances of the case concerned, especially the legal and contractual distribution of risk.

(2) The fact of essential premises that have become the basis of the contract having changed is treated as a change of circumstances.

(3) If it is not possible or a party cannot be required to adapt the contract, the injured party can terminate the contract. Contracts with continued performance are governed by the right to give prior notice of termination instead of the right to terminate.

The current trend in new European contractual law (to be promulgated as the "European Code of Contracts") follows the same lines, bearing in mind that the "Principles of European Contract Law" also deal with the concept of a "change of circumstances" (article 6.111). According to this article, a party is bound to fulfill its obligations even if performance has become more onerous, whether because the cost of performance has increased or because the value of the performance it receives has diminished.

If, however, performance of the contract becomes excessively onerous because of a change of circumstances, the parties are bound to enter into negotiations with a view to adapting the contract or terminating it, provided that: (a) the change of circumstances occurred after the time of conclusion of the contract; (b) the possibility of a change of circumstances was not one which could reasonably have been taken into account at the time of conclusion of the contract; (c) and, the risk of the change of circumstances is not one which, according to the contract, the party affected should be required to bear.

If the parties fail to reach agreement within a reasonable period, the court may: (i) terminate the contract with certain consequences; or (ii) adapt the contract in order to distribute between the parties in a just and equitable manner the losses and gains resulting from the change of circumstances. In either case, the court may award damages for the loss suffered through a party refusing to negotiate or breaking-off negotiations contrary to good faith and fair dealing.

In English law, this principle (with a different construction) finds its expression (beyond the theory of implied terms) in the concept of frustration of a contract, although it has a more rigorous application, as it generally implies termination rather than modification of the contract. The English law solution tends largely towards termination because it is considered difficult to determine how a contract should be adapted, although this is applied restrictively also.

For the more traditional legal commentators, this implies that the parties should try to agree on a modification before having to submit to the courts the need to keep in force or terminate a contract which has become impossible or very onerous to perform.

Commentators on English law consider that, although the German doctrine (contained in article 313 of the BGB) is not perfect, its application by the courts has produced reasonably fair results, which ought to lead English courts to apply the distinction between "frustration" which must result in termination of the contract as the only viable solution for a contract that is completely impossible to perform, and cases where, despite the radical changes, the purpose of the contract can be brought back to life by making an amendment to it. "Frustration" must not be confused with "hardship" (this term has traditionally been used in contracts to mean simply a greater cost or greater burden that

could force the parties to sit down to negotiate) or *force majeure* (which can prevent performance of the contract and relieve the parties, not in cases where the contract can be performed but where an imbalance has occurred between the original obligations stipulated by the parties). The clauses in the contract are hugely important to provide a solution to these problems.

In the United Sates of America, the solution is the same or similar to that in English law.

In Italian law, the principle finds its expression in part in the theory of *presupposizione* (implied terms) regarding the terms implied "in fact" or terms implied "in law" taken into account by the parties, which are the common and objective purpose for the contract, above the individual motives of the parties which do not affect the contract (as opposed to the facts in the Coronation Case, it is the case of false news of the wedding of a friend which does not affect the sale agreement for a piece of jewelry for the occasion), *soppravvenienza (*change of circumstances*)* and *buona fede* which are the three mainstays used by the courts to justify termination or amendment of contracts caused by a change of circumstances. A *presupposizione* or implied term is seen as a term not set out in the contract as the parties did not expect a different situation.

In French law, the principle is regulated in *imprévision* which comes into play where economic circumstances unforeseen at the time of conclusion of the contract make performance of the contract extremely difficult or much more onerous without however making it impossible. *Imprévision* also exists where the price of a good or service, determined in an agreement, no longer matches its objective fair market value found by the judge by referring back to the time of execution of the contract. This term is considered to be restricted to apply primarily to cases of imbalance in the economic obligations, rather than to the achievement of the contractual aims of the transaction.

Spanish case law

The main Spanish Supreme Court Judgments on this matter were handed down in December 14, 1940, May 17, 1941, June 5, 1945, May 17, 1957, June 16, 1983, June 27, 1984, April 19, 1985, October 16, 1989, December 10, 1990, April 23, 1991, June 24, 1993, December 14, 1993, June 19, 1996, September 18, 1996, June 23, 1997, November 15, 2000, May 27, 2002 and November 12, 2004.

Requirements for application in Spain

In summarised terms, the Spanish courts and legal commentators have established that:

A) The *rebus sic stantibus* clause is not recognized in the law.

B) It finds a certain amount of legal support in article 1258 of the Spanish Civil Code and in construal by the courts based on general principles of law;

C) Given its treatment in the doctrine and the principles of equity it can serve, it is allowed by the courts restrictively.

D) If allowed, it must be allowed with caution as it breaks the general principle of *pacta sunt servanda* (contained in article 1091 of the Civil Code).

E) The fundamental premises for it to be allowed are:

a) an **extraordinary change of circumstances at the time of performance** of the contract in relation to the circumstances present when it was concluded;

b) an **exorbitant disproportion**, beyond all calculation, between the obligations of the contracting parties which genuinely defeats the contract by destroying the balance between the parties' obligations;

d) all of the foregoing must have resulted from the supervening occurrence of **radically unforeseen** circumstances at the time of conclusion of the contract; and

c) the party relying on the clause must have acted in **good faith and not be at fault**.

F) As for its effects, to date the Supreme Court has almost always refused to allow the contract to be terminated, and has only agreed for it to be amended to correct the imbalance between the parties' obligations. It lays down that there must not be any other legal remedy to correct that imbalance.

G) Application of the *rebus sic stantibus* clause is even more exceptional in executed contracts (signed and performed at the same time) than in executory contracts (performed over time).

Practical application in Spain: refusal of the *rebus sic stantibus* **principle**

1. It is not applicable in contracts in which the parties have explicitly or implicitly accepted the change of circumstances in the contract (e.g., clause not to review prices, effect of a potential strike, etc.) [Supreme Court Judgment of June 16, 1983]

2. A potential strike at one of the plants of the supplier or the political situation in the country to which they were to be supplied are not, in themselves, circumstances that would allow the clause to be applicable, as they are circumstances that could reasonably have been foreseen by experienced traders such as the parties. [Supreme Court Judgment of June 27, 1984]

3. After the conclusion of a contract of sale for real estate there was a change to the applicable planning/zoning provisions that prevented the whole project being performed, but it was proven that the buyer did not make his purchase conditional on the project being carried out completely, and it was not proven that the price had been determined according to the whole project. [December 14, 1993]

4. It was not applicable in a case of transfer of copyright to a producer to make a film version of a play for the theatre, where two actresses had to be changed, and the production cost had risen, not even if it had been drawn out over time [Supreme Court Judgment of January 29, 1996]

5. The fact that, in a distribution contract, the distributor was in a difficult economic situation as a result of its unsuccessful applications for subsidies did not qualify as an unforeseeable event. [Supreme Court Judgment of June 23, 1997]

6. The sale of vessels by a shipowner who had been provided with several mortgages to finance them, on condition that their use would not be changed and that they would be maintained with the due standard of care, by relying on the difficult situation of the naval industry and the fact that an expected government policy had not been applied is not an unforeseeable event. [Supreme Court Judgment of October 16, 1989]

7. In a lease contract for gaming machines, it was not deemed to be applicable in relation to a change of tax law that had an unforeseeable or profound or unfair supervening effect of causing an imbalance in the stipulated obligations. [Supreme Court Judgment, September 18, 1996]

8. In the case of a project contract for the construction of a mould, the increase in the price of materials is a foreseeable circumstance for a molds trader. [Supreme Court Judgment, May 27, 2002]

9. A currency devaluation is not an unforeseeable event for the parties at the time of signing the contract; a stabilisation clause could have been stipulated [Supreme Court Judgment,

December 10, 1990]

10. It was not applicable in relation to a purported change in the value of land or buildings, which could have been foreseen at the time of signing the contract, because of the increases in value generated on the market, or because a subsequent valuation or adjustment mechanism could have been stipulated [Supreme Court Judgments of October 6, 1987, February 21, 1990, October 26, 1990, April 23, 1991]

11. Nor could it be applied in the case of an increase in value of the building (as subsidised housing) where it was up to the vendor to confirm its status as such which it failed to do, in an installment sale in which no devaluation adjustment (interest) was stipulated from the time of the contract until the delivery.

12. A party that is in default of its obligations cannot seek application of the *rebus sic stantibus* clause. [Supreme Court Judgment of November 15, 2000]

Practical application: amendment to the contract

1. By relying on "interpretation of the contract and good faith" [Supreme Court Judgments of January 5, 1980, November 8, 1983]

2. Application of the *rebus sic stantibus* contractual clause [Supreme Court Judgment 11 of June 1951]

3. The clause was not applicable to random contracts and was applicable to contracts that were affected by a rise in the price of fruit or of land [Supreme Court Judgment of November 23, 1962]

4. The clause was applicable in a case of services which were affected by the construction of a new, more modern, slaughterhouse and an amendment to health legislation which had a material effect on the use of the slaughterhouses, which made the service stipulated in the contract more onerous [Supreme Court Judgment 9, 1984]

5. *Rebus sic stantibus* was upheld in the case of the sale of 50% of a discotheque business, although it does not appear to be applicable [Supreme Court Judgment of November 6, 1992]

Practical application: termination of the contract

1. Termination of a supply contract as a result of a supervening change of circumstances. The energy price was set according to the personality of the buyer and the reseller of the liquid, and their relationships with the company, and they could not have foreseen either the sharp increase in the cost of the liquid or that due to the development of the system of water reserves irrigation could be extended in its current form, with the resulting increase in electricity consumption, "increase in costs and use that have destroyed the balance in the contract, and converted an onerous and commutative contract into a heavy economic burden for the supply company." [Supreme Court Judgment of January 28, 1970]

2. Termination of a manufacture licensing and technical assistance contract upheld by applying the *rebus sic stantibus* clause in an award rendered in an arbitration proceeding (Comercial Ebro S.A. vs. Fred Perry Sportwear Ltd.), in which it was found that the change of circumstances was a modification established by an administrative body [ruling of the

Foreign Trade Authority of 1982 on payments of licensing and technical assistance fees], and the change of circumstances could not be attributed to the party relying on it. The Supreme Court allowed the termination, possibly because of the technical insolvency of the debtor, which made it difficult to restore the initial balance [Supreme Court Judgment of March 23, 1988]

Practical application: lesser case law

1. Cases of refusal (because the circumstances were not unforeseeable):

(a) the downturn in the tourism industry in a lease contract on tourist apartments (Tarragona Provincial Appellate Court Judgment of January 10, 1992);

(b) in the contract for the assignment of a successful bid on an auctioned property, the existence of encumbrances on the property (Granada Provincial Appellate Court Judgment of July 15, 1993);

(c) in a contract for the operation of a bar, bad weather (Valladolid Provincial Appellate Court Judgment of July 21, 1995);

(d) in a lease contract for a dwelling, the downturn in the real estate industry (Barcelona Provincial Appellate Court Judgment of November 16, 1995);

(e) in a contract for the assignment of operation of an insurance broker business, the cancellation of the policies by the insurance company (La Rioja Provincial Appellate Court Judgment of June 29, 1998);

(f) in the assignment of a contract for the operation of a bullring, the termination of the operation contract by the city council (Ciudad Real Provincial Appellate Court Judgment of December 24, 1998);

(g) in a supply contract, the appearance of a much more economical product on the market (Barcelona Provincial Appellate Court Judgment of September 30, 1999);

(h) in a lease contract for a gas station and sales commission as security, the deregulation of fuel prices (Palencia Provincial Appellate Court Judgment, of November 15, 1999).

2. Cases of application:

(a) to amend the contract (Valencia Provincial Appellate Court Judgment of May 17, 1991 and Navarra Provincial Appellate Court Judgment of November 12, 1998)

(b) to terminate the contract (Barcelona Provincial Appellate Court Judgment of February 16, 1993)

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