The impact of supervening illegality on international contracts in a comparative context

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Abstract

This article is a comparative study on the issue of frustration of contracts with a closer look at supervening illegality of international contracts as a frustrating event. The first part of this research mainly discusses how different legal regimes deal with this issue. When a frustrating event occurs, some legal systems apply *pacta sunt servanda* with very little flexibility in terminating (the only caveat being cases of *force majeure*, physical and legal impossibility), or at least adapting, the contract based on new circumstances. Some other legal regimes rule for obligor's relief and subsequent termination of the contract. There are also moderate legal systems that do stand somewhere between these extremes, which frequently adapt the contract to what the parties had intended when concluding the contract. The latter seems to be more appropriate and suitable.

The first part of the article will deal with frustration, while the latter part will focus on the prerequisites and consequences of supervening illegality. A subsequent change in the law, no self-induced non-performance and unforeseeability are the prerequisites in all legal systems. The major consequence is absolute and total discharge of the contract for permanent illegality, while for temporary illegality performance shall merely be suspended.

INTRODUCTION

Regardless of whether one uses the term 'frustration' 'impossibility' or 'changed circumstances', the situation expressed is basically the same. In any legal system it arises 'when unforeseen occurrences, subsequent to the date of the contract, render performance either legally or physically impossible, or excessively difficult, impracticable or expensive, or destroy the known

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utility which the stipulated performance had to either party'.[1] The question raised in such a situation is, of course, whether deviation from the stipulations of the contract should be allowed, by means of the contract's adjustment, postponement or termination.[2] In order to understand the doctrine of frustration of contract, supervening illegality and its consequences on international contracts and arbitration agreements, it is first necessary briefly to examine the development and its current status in various legal systems. After this I shall proceed to the prerequisites and consequences of supervening illegality.

APPROACHES IN NATIONAL LEGAL SYSTEMS

There are generally three different approaches to the problem of frustration in national legal systems. The first approach gives limited relief by special legislation in times of crisis. The second makes specific announcements 'by judicial construction of code provisions prescribing general standards of conduct' while the third gives the power to national courts to adjust the contract based on newly raised conditions.[3] The following is the trend taken by prominent legal systems.

The doctrine of frustration – English law

In English law the concept of 'frustration' has its broadest meaning when it is used as 'frustration of contract'. It embraces the entire doctrine of discharge due to a supervening event either causing destruction of the subject matter, frustration of purpose, or resulting in illegality of the contract determined by law.[4] In fact, the concept is broad enough that some assert it also encompasses, to some extent, features of the concept of *imprévision* in French law and the German *Geschäftsgrundlage*.[5] Frustration is an exception to the globally recognised principle of *pacta sunt servanda* (sanctity of contracts).[6] Therefore the fact that the doctrine is so designed to be applied in specific circumstances and in a limited number of cases has been

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1. Smit *Frustration of contract: a comparative attempt at consolidation* 58 *Colum L Rev* 287, 287 (1958).
2. *Id* at 287–88.
3. *Ibid*.
4. Nehf *Corbin on contracts – impossibility* (rev 2001 Perillo ed) at 5–6.
5. Puelinckx 'Frustration, hardship, force majeure, imprevision, Wegfall der Geschäftsgrundlage, Unmöglichkeit, changed circumstances' (1986) 3 *J Int'l Arb* 47 at 50.
6. Schmitthoff 'Frustration of international contracts of sale in English and comparative law' in *Schmitthoff's selected essays on international trade law* (1937) 254 at 256, citing Rodhe.

welcomed by English courts.[7] As for the meaning of 'frustration of contract' in general, which English law is consistent with, Professor Schmitthoff states that:[8]

> [it] is the phenomenon that the law absolves the parties to a contract from performing their obligations on the ground that an event has happened (I) after the conclusion of the contract, (ii) for which neither party is responsible, and (iii) which is regarded by the law as a valid excuse of performance.

As the history of frustration or impossibility in English law is of special importance, a brief indication to the development of the doctrine is provided below.[9]

Gradual development of the doctrine

In English law the doctrine of frustration developed in several stages. Every stage is based on a different theory. The case of *Paradine v Jane*,[10] decided in 1647, is an example of the 'theory of absolute contract' in English law. This theory represents a strict consideration of the principle of *pacta sunt servanda* by English courts when the duty is created by a party himself in the contract and not by the law, *ie* the party that in any situation, undertook the duty has to perform in accordance with the contract 'notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract'.[11] It should be noted that the application of this theory is not entirely obsolete today.[12]

The second stage in the development started with the case of *Taylor v Caldwell* in 1863, where the defendants rented a music hall to the plaintiffs for a series of concerts. The hall accidentally caught fire and was destroyed before the concerts could take place.[13] In this case the court discharged both

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7 See Lord Radcliff's observations in *Davis Contractors Ltd v Fareham Urban District Council* [1956] AC 696, 121; also see Schmitthoff n 6 above at 255–6 (citing *Nicolene Ltd v Simmonds*).

8 Schmitthoff n 6 above at 255; also see Chitty & Beale *Chitty on contracts* (29ed 2004) at 23–001.

9 For further commentaries see Hay 'Frustration and its solution in German law' (1961) 10 *Am J Comp L* 345 at 348–351.

10 *Paradine v Jane* 82 Eng Rep 897 (KB 1647). Jane was the tenant of Paradine. Rupert, a German prince occupied the property by military force but, nevertheless, the King's Bench ruled that Jane was responsible for paying the rent for the occupancy period; also see Nehf n 4 above a t 3, fn 7 citing *Silverman v Charmac* 414 So 2d 892 (Ala 1982).

11 *Paradine v Jane* n 10 above.

12 See Schmitthoff n 6 above at 257 fn 10.

13 *Taylor v Caldwell* Eng 3 B & S 826 (1863).

parties from performance of their obligations by rejecting the 'absolute contract theory' and invoked an 'implied condition' precedent in the contract.[14] This case restricted the doctrine of frustration to physical impossibility. However later in early twentieth century it was extended to 'legal impossibility'.[15]

In 1952 the gateway to the third stage was opened by the ruling of the House of Lords in *British Movietonews Ltd v London and District Cinemas Ltd*.[16] Different positions were taken by the Court of Appeals and the House of Lords. The former decided the case on the basis that the court has 'a qualifying power' where a frustrating event has occurred without intervention and awareness of the parties. Therefore based on the court's 'inherent jurisdiction', it has the power 'to qualify the terms of [the] contract in accordance with what seems to be reasonable in its eyes',[17] or in other words to 'reconstruct what the parties actually wanted'.[18] However this standpoint on frustration was rejected by the House of Lords (and the Supreme Court) when it applied the 'theory of common intention of the parties. It is clear that the third stage is directed towards assuring that the doctrine of frustration is to be based on the common intention of the parties and so the court may only construe the contract of the parties.

Some five years later Lord Radcliff in *Davis Contractors Ltd v Fareham Urban District Council* stated:[19]

> Frustration occurs whenever the law recognizes that without default of either party a contractual obligation has become incapable of being performed because the *circumstances* in which performance is called for would render it a thing *radically different* from that which was undertaken by the contract. *Non haec in foederaveni*. It was not this that I promised to do.

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[14] The court found that the contract was subject to an implied condition, the existence of the hall when they were concluding the contract; therefore now that the condition is discharged accidentally, the parties ought to be excused from performance, *Taylor v Caldwell* n 13 above.

[15] Schmitthoff n 6 above at 258 (a reminder here that legal impossibility or, in other words, supervening illegality is the thrust of this article).

[16] *British Movietonews Ltd v London and District Cinemas Ltd* [1952] AC 166.

[17] Schmithoff n 6 above at 259.

[18] Puelinckx n 5 above at 49.

[19] *Davis Contractors Ltd v Fareham Urban District Council* [1956] AC 696, 721.

The statement shows that Lord Radcliff formulated the leading approach to frustration which is the applicable test to determine frustration today, 'fundamental changes in circumstances'.[20]

From the following statement it is also understandable that the 'radical change in circumstances' should manifest a 'change significance of the obligation' of one or both of the parties. Therefore hardship, inconvenience or material loss may not result in frustration of the contract in English law. Lord Radcliff continues:[21]

> …that special importance is necessarily attached to the occurrence of any unexpected event that, as it were, changes the face of things. But, even so, it is not hardship or inconvenience or material loss itself which calls the principle of frustration into play. There must be as well such a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing from that contracted for.

In the meantime, it should be noted that the Court of Appeals in *British Movietonews Ltd v London and District Cinemas* Ltd made an effort to justify the court's intervention in *any* subsequent change of circumstances and to accept the broadest meaning for the 'theory of the *clausula rebus sic stantibus*'.[22] However, in *Davis Contractors* Lord Radcliff held that the court may intervene if there is a radical change of circumstances as opposed to 'any' change of circumstances. In addition, the courts may ascertain the common intention of the parties based on an 'objective rule' and irrespective of any individual or subjective criteria:[23]

> By this time it might seem that the parties have become so far disembodied spirits that their actual persons should be allowed to rest in peace. In their place rises the figure of the fair and reasonable man. And the spokesman of the fair and reasonable man, who represents after all no mere than the anthropomorphic conception of justice, is and must be the court itself.[24]

Reference should also be made to the Law Reform (Frustrated Contracts) Act of 1943 on apportionment of down payments or reliance expenses which was adopted to address the lack of such payment recoveries under common law.

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20 Shmithoff n 6 above at 261–2.
21 *Ibid.*
22 *Id* at 260.
23 [1956] AC 696.
24 This view has been approved in later judgments as well; see *Ashworth v Société*, Schmithoff n 6 above at 261 fn 28.

Nevertheless, this statute did not change the analysis of a frustrating event in English law.[25]

Current position

Nowadays in English courts, it is not easy to convince a judge that a frustrating event has occurred.[26] Therefore, to rule that a contract has been frustrated would be considered 'a kind of last ditch … conclusion which should be reached rarely and with reluctance'.[27]

As explained above, to raise frustration and challenge the principle of *pacta sunt servanda* in English law the circumstances must change significantly as the result of a frustrating event and without fault of either party. The extent of this change must be such that the foundation of the contract no longer exists and if performance were still to be required, 'a thing radically different from that which was undertaken by the contract will have to take place'.[28] In English common law the 'doctrine of frustration' automatically absolves the parties from future performances, *ie* obligations which would have been enforceable after the date of discharge.[29] However obligations existed prior to occurrence of the frustrating event remain enforceable.[30]

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25 Rapsomanikas 'Frustration of contract in international trade law and comparative law' (1980) 18 *Duq L Rev* 551, citing Hay 'Zum Wegfall der Geschäftsgrundlage im anglo-amerikanischen Recht' 164 (1964) *Archiv für die civilistische Praxis* 231, 232.

26 See *eg Brauer & Co Ltd v James Clerk Ltd* [1952] 2 All ER 497; also see number of the so-called Suez Canal cases in 1956–67, where ships were chartered during the Arab-Israeli war and the Suez Canal was closed as a result of the Six-day War. Instead, vessels were forced to sail around the Cape of Good Hope. Frustration was rejected in some cases, see *eg Tsakiroglou & Co Ltd v Noblee Thorl GmbH* [1960] 2 WLR 869. However, it seems that frustration was only accepted in cases where the contract was expressly mentioned For Suez as the pathway, see *Albert D Gaor & Co v Société Interprofessionnelle des Oléagineux Fluides Alimentaires* [1960] 2 QB 334 affirmed (1960) 2 QB 348 (CA); *Société Franco Tunisienne D'Armement v Sidermar Sp A* (1961) 2 QB 278 (where the Court saw an obligation to pass through the Suez Canal).

27 Tsakiroglou & Co Ltd v Noblee Thorl GmbH [1960] 2 WLR 869, 884.

28 *Davis Contractors* n 19 above at 729; see features of frustration listed by Judge Bingham in *Lauritzen AS v Wijsmuller BV* [1990] 1 *Lloyd's Rep* 1.

29 In *Joseph v Imperial*, Lord Simon stated: 'When frustration in the legal sense occurs, it does not merely provide one party with a defence in an action brought by the other. It kills the contract itself and discharges both parties automatically.' See Schmithoff n 6 above at 264 fn 42.

30 See *Chandler v Webster* [1904] 1 KB 493, in which the court stated that when a contract is frustrated, its completion is impossible, 'the loss lies where it falls'. That is, 'the obligations prior to the frustrating event remain but all future liabilities are discharged'.

Impossibility under the UCC & the restatement second of contracts – American law

The doctrine of frustration is known as 'impossibility' or 'impracticability' in American law as a common law system. However, 'the doctrines overlap to a great extent, and have developed in tandem in the United States'.[31]

Frustration in English law embraces the entire doctrine of discharge by any supervening event either resulting in the frustration of purpose (to make the contract pointless) or rendering performance of the contract physically or legally impossible. In the American legal system various terminologies are used to describe the concept.[32] Though the outcome depends on the facts and circumstances of each case; there are cases where there is an absolute impossibility but no relief is granted. There are also cases where performance is merely burdensome but discharge is still granted.[33] Generally, in the American system frustration is broken down into frustration of purpose and impracticability or impossibility. In the case of frustration of purpose performance is possible but pointless; while in the case of impracticability or impossibility, performance *per se* is impossible or commercially impracticable.[34] Having said this, there are normally three events that are considered an automatic excuse for non-performance: death of a person who is to perform personally, supervening illegality and destruction of the subject matter.[35] Other events that may justify non-performance include circumstances under which the enforcement of the performance results in an imbalance the in parties' contractual position. In these instances, 'relief is most justified'.[36]

The Uniform Commercial Code (UCC) was approved by a Permanent Editorial Board under the joint auspices of the American Law Institute and the National Conference of Commissioners on Uniform State Laws in 1952.[37] Article 2 of the UCC, regarding sales, contains three sections that state

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31 Nehf n 4 above at 5; in the twentieth century 'impracticability' was used as a standard terminology for frustration, rather than 'impossibility', however today the two are used interchangeably, see Nehf at n 4 above at fn 12.

32 *Id* at 30. *Eg* Physical impossibility, legal impossibility, subjective and objective impossibility, personal inability, increased difficulty, and frustration of object or purpose.

33 *Id* at 30 fn 11 and 13, citing *Albert M Greenfield & Co v Kolea* and *City of Littleton v Employers Fire Insurance Co.*

34 *Id* at 4–5 and 30 *et seq*.

35 See Perillo *Calamari and Perillo on contracts* (5ed 2003) at 514.

36 *Id* citing Gergena 'Defence of judicial reconstruction of contracts' (1995) 71 *Ind LJ* 45, 55).

37 See Schnader 'A short history of the preparation and enactment of the Uniform Commercial Code' (1967) 22 *Miami L Rev* 1.

general principles relieving the seller from performance of his contractual obligations.[38] The most accurate way to explain these sections is to consider the risk which the parties transferred by their agreement.[39]

UCC §2–613 entitled 'Casualty to Identified Goods' addresses a scenario in which the goods are 'identified', and not 'existing',[40] by the parties in the contract and the seller has to deliver the exact goods to the buyer. The section exempts only the buyer from performance if 'the goods suffer casualty without fault of either party', before the risk of loss passes to him.[41] This absolute avoidance of performance applies only when the loss is total. When, however, the loss is partial or the destroyed goods no longer conform to what was 'identified' in the contract, the buyer may either avoid the contract or 'accept the goods with due allowance from the contract price for the deterioration or the deficiency in quantity' (with a reduction in price) and with no further rights.[42]

UCC §2–614 dealing with 'Substituted Performance' recognises that when without fault of either party the agreed method of delivery or its completion becomes unavailable or commercially impracticable, the seller may halt the performance unless a commercially reasonable substitute is available. This exemption also applies to the agreed means or manner of payment when it fails because of domestic or foreign government regulation unless the buyer provides a means or manner of payment which is a commercially substantial equivalent.[43]

Finally under UCC §2–615 regarding 'Excuse by Failure of Presupposed Conditions' (with regard to the seller's assumption of a greater obligation, if any) and §2–614, if the seller's delay in delivery or non-delivery has become impracticable due to contingency reasons (non-occurrence of which was a basic assumption of the contract), the seller will be exempt if he notifies the buyer of the delay or non-delivery.[44] Where part of his capacity

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38 Uniform Commercial Code (UCC) §§ 2–613 to 2–615.
39 Nordstrom *Handbook of the law of sales* (1970) 324.
40 As these two are distinguished in the Code, see Nehf n 4 above at 144.
41 See UCC §2–509 regarding the risk of loss in the absence of breach.
42 *Id* at §2–613(b).
43 *Id* at §2–614(a) and (b).
44 *Id* at §2–615 states: 'Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance: (a) Delay in delivery or non-delivery in whole or in part by a seller that complies with paragraphs (b) and (c) 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

to perform is not affected by unforeseen contingency, the seller must allocate production and deliveries among his customers in a manner which is fair and reasonable.[45] Therefore, to assert a defence which will exempt delivery or excuse his delay, a seller must prove that: (1) a contingency occurred; (2) impracticability of performance was due to the contingency and (3) the non-occurrence of the contingency was a basic assumption of the contract.[46]

A question arising here is whether the exemption applied to the seller is also available to the buyer where consideration cannot be delivered to the seller due to a contingency. As will be discussed later, under the Convention (CISG 1980), the Principles (UNIDROIT), and the European Principles (PECL) exemption apply to both parties where the conditions laid down have been met. The UCC is silent on this matter. However, official comments suggest that relief is also available for the buyer.[47]

Continental *force majeure* under the French Civil Code

As mentioned earlier, frustration and its equivalents in other legal systems are exceptions to the principle of *pacta sunt servanda*, a principle 'apparently carved in stone'.[48] Article 1134 of the French Civil Code encompasses this principle and also the general conditions in which the principle shall accept exceptions.[49]

> Force majeure under French law is an irresistible and unenforceable event which makes the performance of a contract impossible and, therefore, subsequently a contract will be rescinded in French law, and no liability will

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any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid. (b) Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable. (c) The seller must notify the buyer seasonably that there will be delay or non-delivery and, when allocation is required under paragraph (b), of the estimated quota thus made available for the buyer.' For commentaries see Nehf n 4 above at 51 *et seq*; Perillo n 35 above at 554 *et seq*; Jenkins 'Exemption for non-performance: UCC, CISG, UNIDROIT principles – a comparative assessment' (1998) 72 *Tul L Rev* 2015, 2022–23.

45 See UCC §2–615 (b) and Official Comment 1 (unforeseen supervening circumstances).

46 Nehf n 4 above at 55 and the cited cases; also see Perillo n 35 above at 554.

47 See Official Comment 9; Jenkins n 35 above at 2022.

48 Kessedjian 'Competing approaches to force majeure and hardship' (2005) 25 *Int'l Rev L & Eco* 641, 426.

49 Article 1134 provides: 'Agreements lawfully entered into take the place of the law for those who have made them. They may be revoked only by mutual consent, or for causes authorised by law. They must be performed in good faith.' see Puelinckx n 5 above at 55.

> be incurred by a party to it for the nonperformance by such party of his obligations under the contract.[50]

However, French law also draws a distinction between impossibility of performance and economic hardship. This is expressed as the doctrine of *imprévision*.[51]

As far as impossibility of the performance is concerned, in terms of article 1142 of the Civil Code, any obligor that has not fulfilled his obligations under the contract must pay damages. However, when non-performance is due to *force majeure*, or a fortuitous event, article 1148 comes into play and releases the obligor from paying any damages.[52] Article 1148 is not a mandatory norm but rather a default rule from which parties may derogate. This means that parties are free to define *force majeure*, as they wish in order to include or exclude events as *force majeure* in their contractual relationship.[53] Parties may not, however, exclude the application of *force majeure* absolutely from their contract since this 'would run against the good faith principle' stipulated in article 1134 of the Code.[54] It should be noted that it is not a French court will not readily accept a non- performance defence based on *force majeure*, as there is a strong belief in the strict application of *pacta sunt servanda* to contractual obligations. Therefore only in exceptional circumstances is *force majeure* accepted as an excuse for non-performance.[55]

When it comes to the doctrine of *imprevision* or difficulty to perform a contract based on economic situations, the theory (*clausula rebus sic stantibus*) is only applied to administrative cases/contracts and by courts (*tribunaux administratifs*) under the rules of *droit administratif*, where the disputes are not resolved by the rules of the civil law reflected in the *Code*

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50 David 'Frustration of contract in French law' (1946) 28/3 *J Comp Leg & Int'l L Third Series* 4 at 11.

51 See Puelinckxn 5 above at 55.

52 Article 1142 states: 'Any obligation to do or not to do resolves itself into damages, in case of non-performance on the part of the debtor.' However, art 1148, which raises the issue of *force majeure* in French law, stipulates: 'There is no occasion for any damages where a debtor was prevented from transferring or from doing that to which he was bound, or did what was forbidden to him, by reason of force majeure or of a fortuitous event.'

53 Puelinckx n 5 above at 56; Kessedjian n 48 above at 426.

54 See art 1147 which states that the cause for non-performance should be an 'external cause'; Kessedjian n 48 above.

55 See David n 50 above at 12; Puelinckx n 5 above at 55.

Civil.[56] The outcome of such disputes is that when for example a private party is faced with an unforeseen and irresistible event, he requests relief and therefore, rather than terminating the contract, the public party shall 'assent to a modification of the contract or to pay a sum of money to the other party by way of an indemnity'.[57] This is to cover the new onerous circumstances for the obligor in administrative contracts and to allow him to continue performing his obligations under the contract, though it is rejected in civil and commercial cases governed by the Civil Code.[58] Apparently in some domestic civil and commercial cases recent decisions of the Court of Appeals and their approval by the *Cour de Cassation* (France's Court of Last Resort) in some domestic civil and commercial cases are moving in the direction of also accepting economic hardship in such contracts.[59]

The doctrine of '*Geschäftsgrundlage*' in the German legal system – the BGB

As in other legal systems, frustration or impossibility has experienced ups and downs in the German legal system and has been refined on several occasions both before and after World Wars I and II.[60] Initially, courts showed no hesitation in departing from the doctrine of *pacta sunt servanda*.[61] The doctrine which first appeared in court discussions and problem analysis in order to define impossibility, was the 'doctrine of fairness' in terms of which if the debtor was compelled to perform his obligation in a way that would ruin his economic stability, the debtor was discharged from performing the obligation.[62] Later, as a result of inflation caused by the world wars, there were increases in prices, which rendered contract performance burdensome and unfair to debtors. The rise in prices in fact reflected the fall in the value of the currency. Therefore, courts applied the 'equivalence test' to determine the impossibility of the contract. The result of the test would be the inequality of the values of considerations in reciprocal contract, where at least adequacy was expected, *ie* in the case of a lack of equality or adequacy, impossibility would be granted. Use of the equivalence test came to an end with a case in 1920 where both parties refused to accept the only remedy

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56 See David n 50 above at 13.
57 *Ibid*.
58 *Ibid*.
59 See Kessedjian n 48 above at 426.
60 See Cohn 'Frustration of contract in German law' (1946) *J Comp Leg & Int'l L Third Series* 28/4 at 15; also see Hay n 9 above at 358–366 (development of the doctrine).
61 *Id* at 18.
62 *Ibid*.

available under the doctrine of impossibility was discharge of the contract, authorised by the Supreme Court.[63]

Later the principle of *clausula rebus sic stantibus* was revived and updated under the term 'contractual basis'. The Supreme Court further developed the concept by allowing courts to shape contracts based on 'the change in circumstances'. This the courts did in the case of reciprocal contracts, by applying the concept 'claim for adjustment' or *Ausgleichsanspruch*.[64]

This remains, in essence, the position in the German system under the term 'judicial adaptation of the contract' and is based on new conditions arising throughout the life of the contract.

However this is a trend more likely to be followed in cases of hardship rather than those of impossibility or *Geschäftsgrundlage*.[65] The current position is reflected in §313 (1) of the *BGB* (*Bürgerliches Gesetzbuch*):[66]

> If circumstances which became the basis of a contract have significantly changed since the contract was entered into and if the parties would not have entered into the contract or would have entered into it with different contents if they had foreseen this change, adaptation of the contract may be demanded to the extent that, taking account of all the circumstances of the specific case, in particular the contractual or statutory distribution of risk, one of the parties cannot reasonably be expected to uphold the contract without alteration.

When distinguishing impossibility from hardship, §275 (1) of the *BGB* provides: 'a claim for performance is excluded to the extent that performance is impossible for the obligor or for any other person.' Even where

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63 *Id* at 19 fn 26.

64 The revision was proposed and formulated by Professor Oertmann: 'Contractual basis is an assumption made by one party that has become obvious to the other during the process of the formation of the contract and has received his acquiescence, provided that the assumption refers to the existence, or the coming into existence, of circumstances forming the basis of the contractual intention. Alternatively, "contractual basis" is the common assumption on the part of the respective parties of such circumstances.' See *Id* at 20 fn. 30, 31.

65 Rosler 'Hardship in German codified private law – in comparative perspective to English, French and international contract law' (2007) 3 *Euro Rev of Priv L* 483, 490.

66 It should be noted that part (3) of §313 does allow revocation and termination where adaptation is inappropriate: (3) if adaptation of the contract is not possible or one party cannot reasonably be expected to accept it, *the disadvantaged party may revoke the contract*. In the case of continuing obligations, the right to *terminate takes the place of the right to revoke*; also see Rosler n 65 above at 485 and 493–495.

performance is possible but requires expenses 'grossly disproportionate to the interest in performance of the obligee', the obligor may decline to perform.[67] As pointed out, remedies legislated in §275 enjoy priority over the remedies in §313. However, the former 'is applicable in cases where an exchange of performances is grossly inefficient in economic terms because costs far exceed utility' while the latter can apply when the 'exchange of performances is grossly unfair because the price paid for performance is significantly lower than the cost of performance'.[68]

In summary: under English law a debtor's obligations are automatically discharged in cases of frustration. French law still rejects any alteration or adjustment of contracts by courts and the obligor must perform his obligations in the most effective manner. German law stands somewhere between the English and French approaches, in so far as it allows courts to adjust the parties' contract in cases of hardship and impossibility.

INTERNATIONAL RULES ON IMPOSSIBILITY

The United Nations Convention on the International Sale of Goods 1980 (CISG)

The United Nations Convention on the International Sale of Goods adopted on 11 April 1980, to which seventy-six states were party as of 7 July 2010 covers a variety of international sale transactions.[69] Section IV of the CISG, titled 'Exemptions', deals with the issue of impossibility, in articles 79 and 80.[70] Article 79 exempts a party from performing any of his obligations under a contract if that party fails to perform his obligations due to: a) an impediment beyond his control, b) which could not have been reasonably expected by him at the time of conclusion, and c) the impediment's consequences at the time of occurrence could not have been reasonably

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[67] See §275 (2) of the BGB:'The obligor may refuse performance to the extent that performance requires expense and effort which, taking into account the subject matter of the obligation and the requirements of good faith, is grossly disproportionate to the interest in performance of the obligee. When it is determined what efforts may reasonably be required of the obligor, it must also be taken into account whether he is responsible for the obstacle to performance obligor may refuse performance.' (Section 275 (2) of the German Civil Code (BGB) Translation adopted from: http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p0813.) Also see Rosler n 65 above at 495.

[68] *Ibid*.

[69] See http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html (last accessed 8 March 2011).

[70] Article 80 merely emphasises that: 'A party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission.'

avoided or overcome by him.[71] Therefore the article gives a general cause of exemption for any sort of non-performance on the side of the seller or buyer.[72]

Although non-performance will result in exemption, in the Convention, non-performance ought to be due to impossibility and *force majeure* and not frustration of purpose or *imprévision*.[73] Therefore, the defaulting party may not claim exemption under article 79 based on the latter issues.[74] This is due to the interpretation of 'impediment' in article 79 (1); however, 'impediment' includes hardship[75] and economic difficulties, such as unaffordability.[76]

It is further necessary to note that an impediment results in exemption from liability when it is: (a) beyond the promisor's control; (b) clearly the exclusive cause of non-performance; (c) unforeseeable at the time of the conclusion of the contract; and (d) unavoidable by the promisor.[77] Of course, the 'reasonable person test' and the principle of 'good faith' are the basis of

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71 Article 79(1):'A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it, or its consequences.'

72 See Honnold *Uniform law for international sales under the 1980 United Nations Convention* (3ed 1999) at 474, 475; also see generally Lee 'Exemptions of contract liability under the 1980 United Nations Convention' (1990) 8 *Dick J Int'l L* 375; Jenkins n 44 above at 2023.

73 Frustration of purpose appears when the contract becomes pointless though performance is still possible.

74 See Lee n 72 above at 389.

75 See Schwenzer 'Force majeure and hardship in international sales contracts' (2008) 39 *VUWLR* 709, 715–719.

76 See Honnold n 72 above at 484, 485 (as he concludes that 'the application of Article 79 to unanticipated economic difficulties should be consistent with the general principles applicable to this provision: (1) Exemption is confined to barriers to performance (*eg*, delivery or payment); (2) An 'impediment' to performance may result from general economic difficulties and dislocations only if they constitute a barrier to performance that is comparable to other types of exempting causes.' For case decisions on the issue see, ICC arbitral award case 7197 of 1992 (Failure to open letter of credit and penalty clause case) available at: http://cisgw3.law.pace.edu/cases/927197i1.html; (last accessed 8 August 2012); also see Hamburg Arbitration Proceedings (Germany 21 March 1996) (Chinese goods case) available at: http://cisgw3.law.pace.edu/cases/960321g1.html (last accessed 4 May 2011).

77 For detailed comments on these elements and their scope of application, see Honnold n 76 above at 490–494; Jenkins n 44 above at 2024–2027; Kessedjian n 48 above at 419–20; comments by Bund 'Force majeure clauses: drafting advice for the CISG practitioner' (1998) 17 *JL & Com* 381, 386–87; also see in general Lookofsky 'Impediments and hardship in international sales: a commentary on Catherine K Essedjian's "competing approaches to force majeure and hardship"' (2005) *Int'l Rev L & Eco* 643; and Schwenzger n 75 above.

reference in interpreting these elements in terms of the Convention.[78] Finally, matters which are governed by the Convention, though not expressly stated within the Convention are to be settled on the basis of the principles on which the Convention itself is based. In the absence of such principles, the law applicable in terms of the private international law rules of the forum govern the contract.[79] Therefore, domestic law is the gap-filler in these situations.[80]

The UNIDROIT Principles, 2004

The UNIDROIT Principles of International Commercial Contracts (UPICC) are hailed as the most serious effort at harmonising international contract law drafted by individuals not representing states. The Principles' perspective towards 'exemptions' expand the concept beyond what is stated in the CISG and the UCC.[81] Exemption under the Principles is recognised in chapter 6 on 'Performance' and chapter 7 on 'non-performance' either within the ambit of hardship (encompassing frustration, *imprévision* and impracticability) or *force majeure*, which equals impossibility.[82]

Articles 6.2.1 to 6.2.3 starting from *pacta sunt servanda* to the 'effects of hardship are covered under 'hardship'. Article 6.2.1 represents the respect of the UNIDROIT principles for the fundamental principle of 'sanctity of contract' which comes before mentioning any kind of exemption.[83]

Unlike the Convention, though like the European Principles (discussed in the next section), the UNIDROIT gives a definition of 'hardship'. To excuse performance under hardship, 'occurrences of events fundamentally alter[ing] the equilibrium of the contract' is a 'must' though not sufficient. This alteration is a result of increase in the cost of performance or decrease in the

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78 See arts 8(2) and 7(1) of the Convention. It should be noted that the Convention is silent on the consequences of, and the criteria to distinguish temporary and permanent impediments, see Kessedjian's comments n 48 above at 417, 418.

79 See art 7(2) of the Convention.

80 See Honnold n 72 above at 474, 475.

81 See Bonnel 'Unification of law by non-legislative means: the UNIDROIT draft principles for international commercial contracts' (1992) 40 *Am J Com L* 617, 618.

82 See Viscasillas 'UNIDROIT principles of international contracts: sphere of application and general provisions' (1996) 13 *Ariz J Int'l & Comp L* 381, 423 *et. seq.*.

83 Article 6.2.1 of the UNIDROIT Principles states: 'Where the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations…'; this means not mere hardship or impracticability will result in exemption unless tested under 'hardship' articles, see Perillo 'Force majeure and hardship under the UNIDROIT principles of international commercial contracts' (1996) 5 *Tul J Int'l & Comp L* 21; regarding *pacta sunt servanda* under the UNIDROIT, see Viscasillas n 82 above at 423, 424.

value of the performance (consideration).[84] Other conditions that should be met to allow hardship are that the events were not known to the party claiming hardship after a contract's conclusion (the central concern of foreseeability) and, in addition, could not reasonably have been taken into account at the time of conclusion of the contract.[85] The events must be beyond the claiming party's control and the risk should not have been assumed by him.[86]

A point worth noting with regard to the UNIDROIT, is that, unlike the CISG, in cases of hardship it entitles the disadvantaged party to request renegotiations without 'undue delay' to adapt the altered contract in line with current circumstances and reach an agreement with the other party. However, he may however, not withhold performance.[87] If no agreement is reached, and resort is had to the courts, the UPICC authorises the courts to either terminate or adapt the contract in order to restore its equilibrium.[88]

On *force majeure*, article 7.1.7 of the UPICC is very similar to article 79 of the CISG.[89] When it comes to force majeure, it is true to say that the one and only excuse for non-performance is admissible; however due to few conditions[90] this means that there must be an 'impediment beyond [the party's] control' and that party could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.[91]

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84 Article 6.2.2 of the UNIDROIT; see Perillo n 83 above at 22.
85 Article 6.2.2(a)(b); also see Perillo n 83 above at 24, 25.
86 *Id* at (c)(d); also see Perillo n 83 above.
87 Article 6.2.3(1)(2).
88 *Id* at (3)(4); Ole Lando 'A vision of a future world contract law: impact of European and UNIDROIT Contract Principle 37' (2004) *Uniform Commercial Code Law Journal* 4, 39,40.
89 Article 7.1.7 on *force majeure* announces: '(1) Non-performance by a party is excused if that party proves that the nonperformance was *due to an impediment beyond its control* and that it *could not reasonably be expected* to have taken the impediment into account at the time of the conclusion of the contract or to *have avoided or overcome it or its consequences*. (2) When the impediment is *only temporary*, the excuse shall have effect for such period as is reasonable having regard to the effect of the impediment on the performance of the contract. (3) The party who fails to perform must give notice to the other party of the impediment and its effect on its ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, it is liable for damages resulting from such non-receipt. (4) Nothing in this article prevents a party from exercising a right to terminate the contract or to withhold performance or request interest on money due.'
90 Perillo n 83 above at 15.
91 Article 7.1.7 fn 88 above ; Also see *Peckham v Industrial Securities Co* 113 A 799 (Del 1921) and *Löwenschuss v Kane* 520 F 2d 255 (2nd Cir 1975) for the court's understanding

Temporary impediment has been included in the UNIDROIT principles and allows the obligor to postpone his performance, and where there is a prospective inability on the obligor's side normally give the obligee the right to demand assurance of due performance. If this is not forthcoming, the obligee may cancel the contract.[92]

The Principles of European Contract Law (PECL) 2002

The PECL contain two separate provisions; article 6:111 'Change of Circumstances' for hardship and article 8:108 'Excuse Due to an Impediment' for *force majeure*.

As regards hardship, Chapter 6 of the European Principles article 6:111 is subtitled under Chapter 6 of the Principles titled: 'Contents and Effects'. The article itself is titled 'Change of Circumstances' which recalls PECL's faith in *pacta sunt servanda* as an underlying principle.[93] However, the article introduces an exception to the underlying principle and narrows it down. The first part of the article, in addressing the principle of 'sanctity of contract' provides 'even if performance has become more onerous' the party is bound to perform his contract. However, when it comes to exemptions the term used is 'excessively onerous' which allows qualified performance,[94] in the case of an obstacle one degree less than impossibility.[95] To qualify as excessively onerous the performance may, for example, either 'increase in the cost of performance' or 'devaluate the counter performance' (which in itself is sufficient). In essence, the performance of the overturned contract should result in 'exorbitant costs' for one of the parties.[96]

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of 'impediment'. It should be noted that if a delay in performance occurs and an impediment comes after, it will not be an excuse for non-performance, see *International Paper v Rockefeller* 146 NYS 371 (App Div 1914).

92 See art 7.1.7 (4) and 7.3.4 of the UNIDROIT. Also see Perillo n 83 above at 18, 19.

93 Article 6:111(1) declares: '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.' Also see Flambouras 'The doctrines of impossibility of performance and clausula rebus sic stantibus in the 1980 convention on contracts for the international sale of goods and the principles of European contract law – a comparative analysis' (2001) *Pace Int'l L Rev* 261, 286.

94 Article 6:111(2) states: '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 ….' See Lando & Beale (eds) *Principles of European contract law parts I and ii* (combined and rev ed 2000) at 324; also see art 1467 of the Italian Civil Code.

95 Backhaus 'The limits of the duty to perform in the principles of European contract law' (2004) 8 *EJCL* 4.

96 Lando & Beale n 94 above at 324.

The application of part two of the article arises if the change of circumstances occurs after the conclusion of the contract. Further, as in the CISG and UPICC, the change must not be something that could reasonably have been taken into account and the risk of the change should not have been something which one party should anyway bear.[97]

Article 6:111of the PECL provides rules similar to those in articles 6.2.1 to 6.2.3. However, article 6.111(3) also provides that the court may award damages for a loss resulting from a party refusing to negotiate or terminating negotiations contrary to good faith and fair dealing.[98]

On *force majeure*, the European Principles do not use this term, choosing rather 'excuse due to an impediment' which is closer to the terminology in the CISG.[99] The conditions under which this article operates are similar to those in the CISG and the UPICC. However, nothing is provided where the impediment involves 'a third party who has been entrusted by one of the contractual partners to perform part of its own obligations'.[100]

Briefly, the CISG 1980 merely addresses *force majeure* without giving explicit guidance on hardship. On *force majeure* the Convention excuses

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[97] Article 6:111(2)(a), (b) and (c).

[98] Article 6:111(3) provides: 'If the parties fail to reach agreement within a reasonable period, the court may: (a) terminate the contract at a date and on terms to be determined by the court; or (b) 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.' Also see Lando n 88 above at 40 (where he suggests that 'the hardship rules of UPICC or PECL should become part of the Global Code'.)

[99] Article 8:801 states: 'A party's non-performance is excused if it proves that it is due to an impediment beyond its control and that it could not reasonably have been expected to take the impediment into account at the time of the conclusion of the contract, or to have avoided or overcome the impediment or its consequences. (2) Where the impediment is only temporary the excuse provided by this article has effect for the period during which the impediment exists. However, if the delay amounts to a fundamental non-performance, the obligee may treat it as such. (3) The non-performing party must ensure that notice of the impediment and of its effect on its ability to perform is received by the other party within a reasonable time after the non-performing party knew or ought to have known of these circumstances. The other party is entitled to damages for any loss resulting from the non-receipt of such notice.'Also see Flambouras n 93 above at 285.

[100] The issue in PECL, as in the UNIDROIT, is not addressed; in the CISG, however, it is – see art 79(2)). It has been suggested that in the absence of a specific provision to that effect 'it may not prevent a party from using such an occurrence since *force majeure* with a third party may very well be covered by the characteristics of *force majeure* under art 3.108. All will depend upon the exact circumstances of each case'. See Kessedjian n 48 above at 424. Also for further comparison in detail see generally Flambouras n 93 above.

either party from performance when the prerequisites are met: to be an impediment beyond the promisor's control, necessarily the exclusive cause of non-performance, unforeseeable at the time of the conclusion of the contract, and unavoidable by the promisor. However, UNIDROIT and PECL rules cover both *force majeure* and hardship. In the case of hardship these rules do not automatically discharge parties from their obligations but the disadvantaged party is entitled to renegotiate new circumstances, and then if renegotiations fail parties may resort to court and the court may either terminate or adjust the contract. In *force majeure*, the parties may terminate the contract, withhold performance or claim damages.

SUPERVENING ILLEGALITY: PREREQUISITES AND CONSEQUENCES

If an agreement is illegal when concluded, the issue is a matter of illegality. However; when an agreement is legal when concluded, but later becomes illegal or its performance becomes illegal due to an enactment of subsequent legislation, an order or decree issued by court, or the outbreak of war, the issue is no longer illegality. Rather it becomes a matter of supervening illegality.[101] In what follows supervening illegality as a frustrating event is specifically considered. In this regard, we shall consider the reason behind this frustrating event as will the contradiction between party autonomy and public policy. Before discussing the consequences of supervening illegality prerequisites must be examined. Finally, the consequences of permanent and temporary illegality will be canvassed.

Why does an initially legal contract turn illegal?

A contract in international trade concluded in accordance with the law may subsequently become illegal by a change in the law or an act by the government. This subsequent change in the law is defined as supervening illegality.[102]

Disregarding political concerns, states issue decrees affecting international trade on considerations of public policy in war-time, (so-called 'trading with the enemy' prohibitions), when domestic industry is at risk because of the high level of imports (import and export controls), or even when a state does not comply with its international obligations and the international community

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[101] See Perillo n 35 above at 523; also see *Avery v Bowden* (1856) 5 E & B 714, in which a ship was supposed to pick up some cargo at Odessa. With the outbreak of the Crimean War, the government made it illegal to load cargo at an enemy port, so the ship could not perform its contract without breaking the law. The contract was therefore frustrated.

[102] Treitel *Frustration and force majeure* (2004) at 319.

pressurises it by applying trade sanctions. Therefore, since states prefer direct participation in international transactions, their intervention will result in sudden changes in policy, supervening prohibitions, or any other government decree which will disturb the performance of a valid contract.[103] In many cases, therefore, the answer to the question posed is the matter of public policy.

A classic case before judges: party autonomy versus public policy

An interesting issue is the conflict between party autonomy and public policy, or interest, in supervening illegality cases. A contract that was legally concluded by the free will of the parties, is later frustrated due to the act of a government.[104] If the case is before a judge who is bound to respect the forum's public policy (assuming that the forum is the place of performance) on the one hand, and also has the duty to respect the parties' choice of law (reflecting the free will of the parties) on the other,[105] which principle prevails in his decision-making in the case of conflict?

On the principle of party autonomy, an ICC award held that there are few more universally recognised principles in private international law than the principle 'according to which the law of the contract is the law chosen by the parties (party autonomy)'.[106] The trend in national laws and international rules is that when deciding the applicable law to an international transaction; primary place is accorded to the will of the parties. However, Maniruzzaman convincingly points to the limits to this freedom of choice where he states:

> Although the parties' freedom of choice is a general principle of private international law and is to be respected in principle, it should operate within

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[103] *Id* at 320 *et seq*; for the case review, see the English cases *Anglo-Russian Merchant Traders and Batt* [1917] 2 KB 679 (CA), *British Movietonews v London & District Cinemas* [1950] 2 All ER 390 (CA) and for American cases see: *Caldwell Foundry & Mach. Co v Texas Constr Co* 224 F 2d (5th Cir) and *North German Lloyd v Guaranty Trust Company* 244 US 12, 37 S Ct 490, 61 L Ed 960 (1917).

[104] Imagine a scenario where 'A' works for a North Korean electronics supply firm that sells components globally. The company has an existing contract with a client based in the United States. For some reason, the United States government introduces a sanction against North Korea, and places an embargo on all imports from this country. Because of the *supervening illegality*, the supply contract with the client is invalidated.

[105] Lazareff 'Mandatory extraterritorial application of national law' (1995) 11 *Arb Int'l* 137, 140.

[106] See ICC Case 1512 (preliminary award) (1971) 1 *Yearbook: Commercial Arbitration* 128, 128–129.

> the limits imposed by such equally important general principles of law or subject to any restraint of public policy.'[107]

Therefore when a judge is confronted with a case where the will of the parties is obstructed by a change of law and he is to some extent bound to respect the forum's change of law, he has no option but to disregard the parties' choice and rule for the illegality of the contract. In this way, public policy (the basis for the change of law) prevails.[108]

ESSENTIAL PREREQUISITES FOR SUPERVENING ILLEGALITY

One of the main categories of supervening illegality is when a contract becomes illegal due to the enactment of a new law.[109] The new law takes the place of the former law on which the contract was based and validly concluded. In some cases the new law has no retrospective effect and the conclusion of the contract remains valid though its prospective performance becomes illegal due to the change of law.[110]

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107 Maniruzzman 'International arbitrator and mandatory public law rules in the context of state contracts: an overview' (1990) 7/3 *J Int'l Arb* 53, 54; also for more analysis of the contradiction between public policy, mandatory rules and party autonomy, see in general, Moss *International commercial arbitration: party autonomy and mandatory rules* (1999). Chukwumerije *Choice of law in international commercial arbitration* (1994); Blessing 'Mandatory rules of law versus party autonomy in international arbitration' (1997) 14 *J Int'l Arb* 23 19 97; Muir-Watt & Radicati di Brozolo 'Party autonomy and mandatory rules in a global world' (2004) 4 *Global Jurist Advances*; and Zhangparty 'Autonomy and beyond: an international perspective of contractual choice of law' 2006 *Emory Int'l L Rev* 511.

108 For cases on the issue of public policy and party autonomy, see *Egerton v Brownlow* (1853) 4 HLC 1*; Mastrobuonu v Shearson Lehman Hutton Inc* 514 US 52, 55 (1995); *Peh Teck Queen v Bayerische Landesbank Girozentrale* [2000] ISLR 148 (CA); *Scherk v Alberto-Culver Company* 417 US 506, 510–511; *Vita Food Products Inc v Unus Shipping Co Ltd* [1939] AC 277, 270; *Volt Information Science, Inc v Board of Trustees of Leland Stanford Junior University* 489 US 468,479 (1989); also see the famous American case of *Mitsubishi Motors v Soler Chrysler-Plymouth* 473 US 614 (1985) (this case addresses the issues of arbitrability of anti-trust cases as a matter of public policy, however, the Supreme Court, notwithstanding the decision of the Court of Appeals, grants arbitrability; here party autonomy prevailed in one sense).

109 Nehf n 4 above at 191 *et seq* (categories of supervening illegality).

110 See Speidel 'Contract excuse doctrine and retrospective legislation: the Winstar case' (2001) *Wis L Rev* 795 (2001) ('sometimes the change (of law) is totally prospective and has no effect on contracts entered before the legislation's effective date. In other cases, the change has some retrospective effect, ranging from *ex post* invalidation from the date of the contract, to impairment of future performance under an existing contract. In these latter cases, the new law, even if prospective in application, may have explicit or implicit retrospective effect in that future contract performance is made illegal, prevented, hindered, or made more expensive by the subsequent government act'); also see generally Troy 'Toward a definition and critique of retroactivity' (2000) 51 *ALA L Rev* 1329.

It is well settled that supervening prohibition of performance by law or administrative regulation provides an excuse for non-performance, and discharge may be granted where other requirements have also been met.[111] For example, when the law intervenes because of the promisor's fault, his duty may not be discharged, first because of a contributory fault by the promisor and second because the impossibility is a subjective one. Therefore, if the promisor's wrongdoing is the reason for the prohibition of the performance (*eg* due to an injunction) his defence will not be accepted.[112]

A non-judicial action by a government agency preventing a party from performance has been held to be an excuse. However, a judicial action may also be considered an excuse.[113] Prevention by order or decree of a court is a judicial action.[114] Under most circumstances prevention by a court is not a valid excuse for non-performance. However, if the court prevention is not due to the fault or breach of the promisor it shall be considered as an excuse to discharge him from his obligation.

It should be noted that if a promisor assumes the risk of a change in law or other government action, his assumption will result in a rejection of the defence of supervening illegality.[115] Prohibition by foreign law is also accepted as an excuse for non-performance though this has not always been the case.[116] Discharge is not usually granted in cases of refusal of a licence

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[111] See §264 of the Restatement 2nd of Contracts which states: 'If the performance of a duty is made impracticable by having to comply with a domestic or foreign governmental regulation or order, that regulation or order is an event the non-occurrence of which *was a basic assumption on which the contract was made*.' Also see §264, comment (a); *Harwell v Growth Programs* 451 F 2d 240 (5th Cir 1971).

[112] Perillo n 35 above at 524 citing *Klauber v Sandiego Street Car* 95 Cal 353, 30 P 555 (189 2); on subjective impossibility, see Nehf n 4 above at 34.

[113] Perillo n 35 above at 524; for non-judicial action, see *Eastern Air Lines v McDonnell Douglas* 523 F 2d 957 (5th Cir 1993), where informal governmental pressure excused late performance and also *Harriscom Svenska v Harris* Corp 3 F3d 576 (2d Cir 1993), where the court excuse non-performance; for judicial action to be possible as well, see UCC §2–615(a) and §264 of the Restatement 2nd, comment (b).

[114] *Id* at 205–7, citing *Moller v Herring* 255 F. 670, 3 ALR 624 (5 th Cir 1919) and *Kansas Union Ins Co v Burman* 141 F 835 (8th Cir 1905); also see Perillo n 35 above at 524.

[115] Perillo n 35 above at 524, also see §264 of the Restatement 2nd, comment (a).

[116] See the explicit position of the UCC §2–615(a) and comment (4); §264 of the Restatement 2 nd ; *Texas Co v Hogarth Shipping* 256 US 619 (1921), where the ship was requisitioned by the British government; for further comments see Perillo n 35 above at. at 525 and Nehf n 4 above at 233 *et seq*.

or permit when the promisor knows that a licence or permit is required,[117] unless the duty has been made conditional upon granting of a licence.[118]

Outbreak of war may also make a performance either burdensome or impossible and may result in discharge of the promisor's duty. However, it normally does not discharge the promisor and the outcome often 'turns on the type of event precipitating the impossibility claim and the degree of increase in costs'.[119]

In accordance with what has been said above and cases cited, the essential prerequisites for supervening illegality (applicable in any such cases), in order to be considered an excuse for non-performance can be listed as follows:

- There ought to be a subsequent change of law which renders a valid contract or its performance illegal.
- Illegality should not be caused by the contributory fault of the party claiming excuse, in other words, it should not be self-induced.
- The risk of a change of law could not reasonably have been assumed or expected by the party claiming excuse (foreseeability).

COMMON CONSEQUENCES OF SUPERVENING ILLEGALITY ON CONTRACTUAL LIABILITIES

The preceding sections of this article explained the basis of supervening illegality and that, in international trade it refers to situations in which subsequent changes in the applicable law make the performance of international contracts legally An overview of the primary consequences of frustration and *force majeure* in the common and civil law systems was also provided. The current section analyses the principles which will result in the right to claim discharge when a valid contract becomes impossible to perform or performance cannot be sustained – in particular because of supervening illegality. The consequences of discharge when one party has performed his obligation partially or entirely before the occurrence of a supervening event; and whether parties can claim damages despite a discharge of contract, and if so, based on what principles will be examined.

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117 Nehf n 4 above at 211, citing *Palmquist v Allardyce Petroleum Corp* 164 Mont 178, 520 P 2d 783, 785 (1974). This includes refusal to give a permit due to embargoes against export or prevention of sailing, see *Allanwild Transport Corp v Vacuum Oil Co* 248 US 377, 39 S Ct 147, 63 L Ed 312, 3 ALR 15 (1919).

118 Nehf n 117 above citing *Edward Maurer Co v Tubeless Tire Co* 285 F 713 (6th Cir 1992).

119 *Id* at 230, 231 and cited cases; but also see *Held v Goldsmith* 153 La 598, 96 So 272 (1919) (contract by German to ship goods to US on British vessel discharged by outbreak of war between Germany and Britain).

There are a few assumptions that should be taken into account:

- Despite the fact that international contracts are supposed to be governed by the principle of party autonomy (as in domestic contracts) which enables the parties to address any issue in their agreement,[120] such contracts are silent on the issue of supervening illegality, *ie* no contractual regulation of supervening illegality (*force majeure* or hardship clauses) by the parties. Therefore the question of the allocation of the risk of loss is left to national courts and arbitral tribunals.
- The international transactions transcend national boundaries and therefore are usually concluded in one country and performed in another country. Certain contracts may even involve a third party (*eg* agent, carrier, bank *etcetera*.).
- Finally, although every legal system has its own framework within which to address cases of illegality, the parties may, despite the radical change in circumstances, rather elect to maintain their contract, probably by considering mechanisms for suitable adaptation of contracts to frustrate or overcome the effects of supervening illegality.[121]

The following is an analysis of basic principles related to discharge and adaptation affected by supervening illegality (permanent illegality), provided by the doctrines of frustration in common law and *force majeure* in civil law.

Discharge and adaptation

As pointed out, in English law supervening illegality is discussed and categorised under the doctrine of frustration. Therefore, the primary consequence of supervening illegality will be the discharge of a frustrated contract, if all requirements have been met.[122] Assuming that these requirements have been fulfilled, the parties will be automatically and totally discharged from their contractual obligations from the moment the new law comes into effect.

As stated earlier, the principle of automatic and total discharge applies to future obligations. The problem arises where the promisee has fully or

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[120] Redfern & Hunter with Blackaby & Partasides *Law and practice of international commercial arbitration* (4ed 2004) 315 *infra*.

[121] For such mechanisms in general see Konarski 'Force majeure and hardship clauses in international contractual practice' 2003 *Int'l Bus LJ* 405; and for arbitration in particular, see Strohbach 'Force majeure and hardship clauses in international commercial contracts and arbitration' (1984) 1 *J Int'l Arb* 39, 40, 41; Melis 'Force majeure and hardship clauses in international commercial contracts in view of the practice of the IC Court of Arbitration' (1984) 1 *J Int'l Arb* 213, 214

[122] See the recent case of *Saipem Spa v Rafidain Bank and others* [2007] EWHC 3119 (Ch).

partially performed his obligations (one-sided performance) and the promisor is now no longer legally permitted to perform his part of the obligations. The early English judicial practice was flexible towards the principle of absolute and total discharge in frustration cases. In fact the court did not reimburse the party who had performed.[123] However, in 1943 the House of Lords in the *Fibrosa* case applied *the principle of total failure of consideration* and finally ordered restitution in favour of the Polish buyer.[124] Therefore, under common law, when the promisor fails to perform his obligations, the other party to the contract is also discharged from performing his part. This is not because the promisor's 'performance is prohibited or prevented, but because it is not required to give something for nothing'.[125]

The English Law Reform (Frustrated Contracts) Act of 1943, which governs all English contracts frustrated by supervening illegality, impossibility, and essential change of circumstances, is also critical in this regard. In addition to reimbursing the prepaid party including any benefits he may have obtained, the Act also gives the courts power to adjust contracts according to the court's sense of just solution in each case.[126] This power would also

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[123] See the two famous English cases *Krell v Henry* [1903] W KB 740 (the court decided that the deposit must remain with the renter) and *Chandler v Webster* [1904] 1 KB 493. (where the court decided not only that would the deposit remain with the renter, but also that the hirer had to pay the full amount).

[124] *Fibrosa Spolka Akcyjna v Fairbairn, Lawson, Combe, Barbour* Ltd [1943] AC 32. (the case was such that Fibrosa, a Polish company, agreed to buy machinery for £4 800 from Fairbairn, an English-based company. In July 1939 Fibrosa made a payment of £1 000 as part of the agreement. By September Germany had invaded Poland and Britain had declared war. Fibrosa attempted to recoup the payment but Fairbairn refused, arguing that the invasion frustrated the contract. The lower courts followed the decision in *Chandler v Webster* which stated that when a contract is frustrated, since completion is impossible, 'the loss lies where it falls'. Later the House of Lords found in favour of Fibrosa and stated: 'It is clear that any civilized system of law is bound to provide remedies for cases of what has been called *unjust enrichment or unjust benefit*, that is to prevent a man from retaining the money of or some benefit derived from another which it is against conscience that he should keep.'

[125] See Nehf n 4 above at 192.

[126] Law Reform (Frustrated Contracts) Act 1943 Ch. 40 6 & 7 Geo 6: Section 1(2) declares: '*All sums paid or payable* to any party in pursuance of the contract before the time when the parties were so discharged (in this Act referred to as 'the time of discharge') shall, in the case of sums so paid, be recoverable from him as money received by him for the use of the party by whom the sums were paid, and, in the case of sums so payable, cease to be so payable: Provided that, if the party to whom the sums were so paid or payable incurred expenses before the time of discharge in, or for the purpose of, the performance of the contract, *the court may, if it considers it just to do so having regard to all the circumstances of the case*, allow him to retain or, as the case may be, recover the whole or any part of the sums so paid or payable, not being an amount in excess of the expenses so incurred.' Also see Section 1(3) which provides: 'Where any party to the contract has, by reason of anything done by any other party thereto in, or for the purpose of, the

appear to apply to arbitrators.[127] The conclusion arising from both the Act and the *Fibrosa* case is that in English law adaptation is limited to judicial revision in situations where down-payments are made before contract's frustration. This suggests that in balancing a one-sided performance with the will of the contracting parties, the concept of adaptation or modification should be taken into account in its broader application.[128]

Under the civil law system the consequence of supervening illegality is discharge in cases of *force majeure*. This corresponds to the main consequence as stated above in common law. The principle of *impossibilium nulla obligatio* in civil law initiates grounds for discharge of both parties from further performance when the contract becomes legally impossible to perform.[129] In order to include unforeseen and uncontrollable events which make contracts economically impossible, concepts of *imprévision* and *Wegfall der Geschäftsgrundlage* were mentioned. However, different approaches have been taken by France and Germany (as the main Civil law systems) towards adaptation of contracts to new circumstances.

As mentioned earlier, the concept of *imprévision* in French law is only applicable to long-term public contracts governed by administrative law.[130] The most liberal trend is found in German law. Whenever contracts become impossible because of disappearance of the basis of contract, the courts are empowered to adapt contractual terms.[131] *Wegfall der Geschäftsgrundlage* is applied in judicial practice to adapt the contract when radical changes in circumstances have occurred and the contract offers no solution by which to maintain its enforceability and there is no indication of the intention of the parties.[132]

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performance of the contract, *obtained a valuable benefit* (other than a payment of money to which the last foregoing subsection applies) before the time of discharge there shall be recoverable from him by the said other party such sum (if any), not exceeding the value of the said benefit to the party obtaining it, *as the court considers just*, having regard to all the circumstances of the case and, in particular, (a) the amount of any expenses incurred before the time of discharge by the benefited party in, or for the purpose of, the performance of the contract, including any sums paid or payable by him to any other party in pursuance of the contract and retained or recoverable by that party under the last foregoing subsection, and (b) the effect, in relation to the said benefit, of the circumstances giving rise to the frustration of the contract.'

[127] Schmithoff n 6 above at 266.

[128] For further detailed discussion see Treitel n 102 above at 532–535.

[129] *Id* at 180–1.

[130] Draetta, Lake & Nada *Breach and adaptation of international contracts, an introduction to lex mercatoria* (1992) 178–187.

[131] Hay n 9 above at 361 *et seq*.

[132] *Ibid*.

The civil law takes the same position as the common law, as far as cases of one-sided performance are concerned. Since *force majeure* affects contracts only from the moment of the occurrence of a supervening event, the parties are excused from all future performance. The civil law allows courts to decide on restitution in order to reinforce a just solution that requires that a loss must be shared, instead of being borne by one party.[133]

Restitution

When courts are deciding on supervening illegality cases, they attempt to leave the parties in the position they were before illegality occurred. Therefore, discharge seems to be a fair and reasonable decision when performance has not taken place by either of the parties. Furthermore, damages cannot be provided as a remedy, as non-performance is not due to the party claiming exemption, but to a supervening event.

However, where one party has partly or fully performed his duty before discharge, a just solution requires that he be restored to the position in which he enjoyed performance and discharge.

The French *Code Civil* provides a right to restitution in such a case.[134] Moreover, as mentioned above, the English Law Reform (Frustrated Contracts) Act has ruled for restitution.[135] A similar solution is provided in American law under the Restatement Second of Contracts which regulates the position where a party has performed his part of his contractual duty before the supervening event.[136] The right to restitution is based on the principle of unjust enrichment, regardless of whether the performing party suffered a loss because of performance or not. Therefore, restitution seems to be accepted as the most adequate remedy to restore the parties to their original positions and a fair method of allocation of risk from loss.

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133 Treitel n 120 above at 535.

134 Article 1183 of the Code provides: 'A condition subsequent is one which, when it is fulfilled, brings about the revocation of the obligation, and which puts things back in the same condition as if the obligation had not existed.'

135 Section 1(2) of the Act provides: 'All sums paid or payable to any party in pursuance of the contract before the time when the parties were so discharged … shall, in the case of sums so paid, be recoverable… .'

136 See §377 of the Restatement which states: 'A party whose duty of performance does not arise or is discharged as a result or impracticability of performance, frustration of purpose, non-occurrence of condition or disclaimer by beneficiary is entitled to restitution of any benefit that he has conferred on the other party by way of part performance or reliance.'

A glance at temporary and uncertain duration

When parties are contracting they cannot always foresee whether a subsequent event will take place or if it does occur, how long it may persist. In cases of supervening illegality the parties would not know whether legislation could be temporary or permanent. A general rule applicable in all cases of impossibility (including embargoes and government regulations) is that the promisor is not discharged from his obligations until 'it can be shown that the supervening events have made it impossible to render substantial performance in a timely manner'.[137] Therefore, when impossibility arises in situations where illegality is temporary, the contract is not frustrated, performance is merely suspended.[138] However, if forcing the promisor to perform his obligations, after impossibility has ceased, 'would impose a burden on the promisor substantially greater than would have been imposed upon him had there been no impossibility',[139] it is fair and reasonable that the promisor be discharged.

Obviously where the promisor has not performed the contract and non-performance is regarded as 'breach', the promisee is entitled to terminate the contract on the grounds of material breach. However if non-performance is excused on the grounds of impossibility, in this instance temporary illegality, the promisee is usually bound to future performance.[140] On the side of the buyer, it has not been suggested that he should compensate the seller who remained ready to deliver, or for capital invested in the goods awaiting delivery, while performance was impossible.[141]

Uncertain illegality occurs when the contract becomes illegal although the duration of its illegality cannot be reasonably anticipated. When impossibility is shown to be of 'uncertain duration', it will be deemed

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[137] Nehf n 4 above at 222; see §269 of the Restatement Second of Contracts which states: 'Impracticability of performance or frustration of purpose that is only temporary suspends the obligor's duty to perform while the impracticability or frustration exists but does not discharge his duty or prevent it from arising … .'

[138] Patterson 'Temporary impossibility of performance of contract' (1961) 47 *Va L Rev* 798, 803. (Patterson plausibly asserts that temporary impossibility is a result of *pacta sunt servanda*, he says: 'Yet the very fact that there is a recognized concept of 'temporary' impossibility is a recognition of the maxim, pacta sunt servanda.')

[139] In this regard §269 of the Restatement Second of Contracts emphasises the protection of the promisor by providing that temporary impossibility does not discharge the promisor, '…unless his performance after the cessation of the impracticability or frustration would be materially more burdensome than had there been no impracticability or frustration' otherwise the promisor's duty is merely suspended while the impossibility exists.

[140] Patterson n 138 above at 806.

[141] *Ibid.*

'permanent', and the promisor will be discharged on the grounds of supervening illegality.[142]

FORCE MAJEURE CLAUSES: CAN SUPERVENING ILLEGALITY BE CONTRACTUALLY REGULATED?

Force majeure and hardship clauses are inserted in (international) contracts, by the parties irrespective of the law governing the contract.[143] They are included in order for parties to self-regulate, so to speak, the consequences of supervening events which occur unexpectedly. Hardship clauses are aimed at bringing the parties to the table and renegotiating the terms of the contract in order to maintain its enforceability despite the new situation. However, *force majeure* clauses grant the right to terminate a contract to the party who has an obligation to perform. The terminating party may, under certain circumstances, be entirely excused from responsibility for his non-performance.[144]

Such clauses may apply to any form of impossibility or *force majeure* event when drafted accurately and comprehensively. However, their application in supervening illegality cases is somewhat limited and inflexible.[145] The issue arising is whether the parties can freely agree on a definition of supervening illegality, formulate their own list of supervening events. In other words, is it possible to assume that such clauses can be used to exclude supervening illegality as a frustrating or *force majeure* event (and probably maintaining contract's enforceability)? As stated earlier, public policy is the foundation and basis for legislators to declare current law void and adopt a new law instead, or for states to issue sanctions, embargoes or decrees. When supervening illegality is a matter of public policy, is it possible to exclude its effects by contract?

Due to public policy incentives, at least the English judicial practice does not allow such alteration or intervention by the parties. Thus, regardless of the

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142 *Id* at 803, citing *Pacific Trading Co v Louisiana State Rice Milling Co* 215 La 1086, 42 So 2d 855 (1949) and *Pacific Trading Co v Mouton Rice Milling Co* 184 F 2d 141 (8th Cir 1950). For a case where induction into military service in wartime was deemed to be uncertain and considered as 'permanent', see, *Marshall v Glanvill* [1917] 2 KB and for where an indefinite internment of an alien enemy was regarded as uncertain and respectively 'permanent', see *Unger v Preston Corp* [1942] 1 All ER 200.

143 Konarski n 121 above at 405, 407.

144 Strohbach n 121 above at 39, 40.

145 Treitel n 102 above at 320, 321 (It has been asserted that in the modern law since the grounds for supervening illegality is separate from physical impossibility, the rules governing impossibility cases do not govern supervening illegality).

force majeure clause, a contract shall be discharged when supervening illegality occurs.[146] Although contractual regulation of supervening illegality is not widely available, there are situations in which it is flexibility – but only in determining remedies and damages. For example, when a contract stipulates that obtaining an export licence is an absolute obligation resting on one party, non-compliance with this explicit obligation may exclude frustration by supervening illegality. The point is that the contract would have been frustrated in any case, but the explicit absolute obligation stipulated in the contract results in damages that must be paid by the party who failed to obtain the licence, though the performance is still impossible (regulating secondary consequences).

CONCLUSION

Having briefly presented the development and current state of how different legal regimes have dealt with the problem of frustration, the following general characteristics can be traced in all national jurisdictions: (a) occurrence of an event after the conclusion of a contract; (b) exceptionality and unforeseeability of the event; (c) alteration of the contract to an intolerable degree; and (d) no fault on the obligor's part.

The differences in treatment is based on a scale where at one end, when a frustrating event occurs, the system fully appreciates *pacta sunt servanda* with very little flexibility in terminating (the only caveat being cases of *force majeure*, physical and legal impossibility) or at least adapting the contract based on the new circumstances (the French system). At the other end of the spectrum there are systems with fluent rules for a party's relief and subsequent termination of the contract (more prevalent in the English approach and less so in the American system as it stands somewhere in between). There are also legal systems that do stand somewhere between these extremes and which frequently adapt (especially in cases of hardship) the contract which seems more appropriate and suitable *eg* (the German

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[146] See *Ertel Bieber Co v Rio Tinto Co Ltd* [1918] AC 260, where the contract expressly provided that only outbreak of war may suspend certain contractual obligations but the House of Lords ruled that according to public policy, the contact must be discharged, Lord Sumner asked: 'If upon public grounds on the outbreak of war the law interferes with private executor contracts by dissolving them, how can it be opt to a subject for his private advantage to withdraw his contract from the operation of the law and claim to do what the law rejects, merely to suspend where the law dissolves?' *Id* at 286; also see the same opinion expressed in *Constantine Line v Imperial Smelting Corporation* [1942] AC 154 (discharge by supervening illegality, unlike frustration by supervening impossibility, is not dependent on the express terms and the surrounding circumstances of the contract).

approach, UNIDROIT and PECL). However, the basis and methodology used in adaptation is important. A formula which results closer to what parties had intended when concluding the contract is preferred to an absolute reconstruction by courts of the contract based on new circumstances.

When a validly concluded contract becomes illegal due to a subsequent change in law, performance the contract becomes illegal and impossible and supervening illegality validates non-performance. The prerequisites for such an excuse are that there must be a subsequent change in the law, non-performance must not be self-induced and the party claiming the excuse could not reasonably foresee or expect illegality. The major consequence of permanent supervening illegality is absolute and total discharge of the contract while for temporary illegality performance is merely suspended. The primary consequence of discharge may not be regulated by *force majeure* clauses. However allocation of loss can be regulated in advance by the parties.