Change of circumstances: CISG, CESL and a case from Scotland

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Article 79 CISG exempts from liability in damages any party to a sales contract unable to perform its obligations due to an impediment beyond its control which it could not reasonably have been expected to have taken into account when the contract was concluded, or to have avoided or overcome. Schlechtriem and Schwenzer observe:

[I]n contrast to the CISG, many legal systems as well as projects for a uniform contract law contain a separate provision for hardship, which applies not only to cases of mere increased difficulty for performance or the decrease in value of the performance, but also to cases of frustration of purpose. In terms of legal consequences, these rules require the contract to be adapted or at least require that new negotiations be entered into. They thus offer greater flexibility than the CISG and, to that extent, are preferable.¹

To the uniform contract law projects cited by Schlechtriem and Schwenzer may now be added the European Commission’s Proposal for a Common European Sales Law (CESL), published in October 2011. Article 88 provides for the exemption from any liability for non-performance of any contracting party unable to perform as the result of an impediment beyond its control or ability to overcome (although the other party may then terminate for fundamental non-performance). Article 89 adds provision for hardship cases, under the heading ‘Change of Circumstances’. While in general increased onerosity has no effect upon the obligation to perform, the parties have a duty to negotiate the adaptation or termination of the contract if it is the result of an ‘exceptional’ change of circumstances occurring after the contract has been concluded. The change must be of a nature or scale that the party relying on it neither did or could have reasonably taken into account at the time of contracting, nor assumed or could be reasonably regarded as having assumed the risk of its occurrence. If the parties fail to reach agreement on what is to be done, then either party (or, presumably, both) may request a court to adapt the contract in order to bring it into accordance with what the parties would reasonably have agreed at the time of contracting if they had taken the change of circumstances into account, or to terminate the contract at a date and on terms to be decided by the judge.

Articles 88 and 89 CESL derive immediately from the Draft Common Frame of Reference provided to the European Commission by an academic group in 2009, which in turn drew upon the earlier Principles of European Contract Law. Unlike the proposed CESL, the DCFR has a commentary, which can be helpful in assessing what a CESL provision may mean. The commentary says that the change of circumstances must be ‘very exceptional’, of a nature that ‘parties to a contract could not reasonably have foreseen when they made the contract’, so that performance becomes ‘excessively and disproportionately onerous’ and leads to a ‘major imbalance’ between the parties’ respective obligations. It may be ‘the direct result of increased cost in performance – for example, the increased cost of transport if the Suez Canal is closed and ships have to be sent round the Cape of Good Hope’. Or it may be ‘the result of the expected counter-performance becoming valueless; for example if a drastic and unforeseeable collapse in an index of prices means that the debtor will be expected to do demanding and extensive work for practically nothing’.

Article 89 CESL however follows PECL rather than DCFR in providing that in such changed circumstances the parties first have a duty to negotiate, and to do so for a reasonable period, before either of them may turn to a court for a solution. Such an approach was rejected in the DCFR as ‘undesirably complicated and heavy’. For example, ‘a creditor in an obligation might be acting in a fiduciary capacity and might be placed in a difficult situation of conflict of interests if obliged to negotiate away its advantage’. Instead of imposing a duty, with its connotations of potential liability for breach thereof, the DCFR made a debtor’s good faith attempt to negotiate a solution to the problem merely a precondition of going to court to have a solution imposed upon an unwilling creditor. In reinstating a duty to negotiate the drafters of the proposed CESL may have thought that the fiduciary example was unlikely to arise in sale of goods cases; but their text does not indicate, for example, what the sanction for refusal to negotiate might be.

In a submission to the European Commission, and again in an advice on the proposed CESL submitted to the United Kingdom Government jointly with the English Law Commission, the Scottish Law Commission criticises draft Article 89 CESL, and in particular the idea of a duty to negotiate before the parties may go to court. In particular the provision would be of little use in consumer sales, given the consumer’s extremely limited...
ability to negotiate with suppliers or to go to court. A more general concern was the potential for uncertainty resulting from the draft Article 89 CESL, even if it could be brought into play only in very drastic circumstances.

At the time, a case raising the issue of the effect of changed circumstances upon a contract was wending its way through the Scottish courts. Although not about sale of goods, the facts of *Lloyds TSB Foundation for Scotland v Lloyds Banking Group plc* provide a good example of a change of circumstances. In brief, Bank L set up a charitable foundation (F) to which it made annual payments based upon a certain percentage of the pre-tax profits shown in its annual accounts, with a minimum payment each year of about £38,000. In 2002 a new accounting requirement came in under which L’s annual accounts had to show in the profit and loss account a sum for any ‘negative goodwill’; that is, the amount by which the capital value of an asset acquired during the year exceeded what had been paid for it where that was the case. In the banking and financial crisis of 2008-2009 Bank L acquired another bank (B) which, although of high capital value, was confronted with liabilities which would probably have bankrupted it but for the takeover. The price paid was therefore much less than the acquisition’s capital value, by some £11.173 billion. The extreme negative goodwill of this rescue operation meant that the 2010 accounts showed Bank L in substantial profit although otherwise on its trading activities it too had suffered severe losses. F claimed the sum produced by calculating the percentage of the profit to which it was apparently entitled on the wording of the contract, some £3.5 million. Bank L, as well as arguing about the proper interpretation of the contract, made a submission that Scots law either already recognised, or should recognise, a doctrine termed ‘equitable adjustment’ enabling the courts to address fairly such cases of changed circumstances. The First Division of the Court of Session issued its opinion in on 29 December 2011 and in doing so, very unusually, made reference to the European Commission’s proposals for a common sales law with a rule allowing court adjustment of a contract to deal with changed circumstances. But the court also took note of the Scottish Law Commission criticisms of the proposal in holding that, at least in Scots law, there was no general judicial power to vary a contract to deal with significant new circumstances arising after the conclusion of the contract.

The case is now being appealed to the Supreme Court of the United Kingdom. This is not the place to consider the basis for the arguments on Scots law. Instead we may ask whether the change of circumstances was of the kind contemplated by the tests of hardship in the proposed CESL and related texts. The change in the accounting rules by itself is clearly not enough, but the collapse and near-collapse of many banks in 2008, and the concomitant threat to the entire global financial system, certainly looks major enough to qualify as of a sufficiently significant nature to trigger change of circumstance rules in relation to contracts the balance of which was disturbed by these events. Thus, while Bank L was struggling to re-stabilise itself, F, which depended upon the bank for its very existence, could claim a windfall resulting from an entirely paper profit which, in the words of one of the Court of Session judges, ‘was neither realised, subject to tax, or capable of distribution’. Undoubtedly the overall arrangement was one intended to provide F with a long-term benefit, without any real return for Bank L other than the continuation of its good name for charitable giving; but it can certainly also be argued that there is an imbalance, or an excessive

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onerosity, in requiring Bank L to pay F the full amount to which it is apparently entitled. Also of some relevance is the observation in the DCFR commentary that there may be a ‘stronger case’ for applying a change of circumstances rule to unilateral and gratuitous obligations (essentially the nature of the obligation undertaken by Bank L and at issue in this case) than to mutual commercial contracts, presumably because imbalance between the parties exists from the outset in unilateral and gratuitous obligations and it should not be allowed to become excessive. Thus F should be assisting Bank L in its time of need, rather than snatching advantage from it.

On the other hand, the example of such a situation given in the DCFR commentary involves the debtor being unable to perform save by selling his house. Elsewhere in the commentary it is suggested that performance must be ‘ruinous’ for the debtor or drive him into bankruptcy before the change of circumstances rule can apply. In our case there is no suggestion that the sum involved would reduce Bank L finally to its knees, with all the deleterious consequences that would involve; were it otherwise, the bank would probably not be undertaking the expensive risk of litigating the matter all the way to the Supreme Court. The payment is a ‘one-off’ brought about by circumstances which pose problems for the bank for one year only. No evidence is led in the case about the amounts of annual payments in previous years by which it might be determined whether the sum at issue was exceptional in its scale. Quite possibly, given Bank L’s continuing struggles, subsequent payments to F will be at a much lower level for years to come. Bank L is thus trying to escape from a bargain which has worked out badly for it at a particular moment; but if the same bargain may well go bad for the other side in future, there is no case for allowing L to do so.

A final point is that it would have suited neither party to plead discharge by frustration of contract, since F could not exist without the bank’s funding, and Bank L wished to preserve its reputation for charitable giving. Given their apparent inability to negotiate a resolution of their dispute despite a shared interest in the contract continuing, the lack of any express term in the contract addressing the specific problem, and the court’s inability to imply a term apparently contradicting the express term that did exist, the only answer other than letting the contract take effect as it stands might seem to be a rule enabling courts to vary contracts to meet major changes in circumstances producing inequitable results. Scottish commentators have certainly advocated such a rule to overcome the perceived inflexibility of frustration. But flexibility may come at the expense of certainty, with the sufferers under bad bargains resorting to litigation as a possible way out of jail. That may give an undue

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12 DCFR, vol 1, p 712.
13 Ibid.
14 Ibid, p 711.
15 F claims on its website (above, note 10) that it has received over £82 million from Bank L under the scheme; although this may have been since it began under different ownership in 1985, simple arithmetic suggests that a payment of £3.5 million may not have been so far above the usual for a year.
16 However, F says on its website (above note 10) that under the interpretation of the contract upheld in the Court of Session it is entitled to a payment of £1.75 million for 2011.
17 Bank L has however already given F notice of termination under other contract terms. This is however of nine years’ duration. Upon termination F will become entitled to a substantial shareholding in Bank L, from which it will be expected to fund its future charitable activities.
advantage to those who can afford to keep litigation running. Recent comparative study shows that most jurisdictions in Europe do not generally allow the application of change of circumstance rules to cases of unexpected benefits, including many that do have rules allowing judicial adjustment of contracts in other kinds of changed circumstances. There seem good reasons, therefore, for jurisdictions and systems which do not have such rules, like Scotland and the CISG, to approach their possible introduction with circumspection and care.