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Contract Enforceability During Economic Crisis: Legal Principles and Drafting Solutions*

Nathan M. Crystal and Francesca Giannoni-Crystal

Abstract

The recent economic crisis, now commonly called the Great Recession, has caused huge financial dislocations. One aspect of the crisis is the effect on contractual obligations: Can a contractual obligation be avoided because of fundamental disruptions in the relevant market? This paper first looks at the common law; there, major market changes are rarely, if ever, the basis of avoidance of a contractual obligation. Restatement and UCC provisions also reflect this "principle of market risk." While case law dealing with the effect of the economic crisis on contracts is thin, the few reported decisions are quite uniform in applying the market risk principle to deny relief.

The second part of the paper considers the extent to which international contract law as reflected in the Principles of International Commercial Contracts (the UNIDROIT Principles) and the Convention on the International Sale of Goods (CISG) provides relief from fundamental market disruptions. Article 6.2.1 of the UNIDROIT Principles recognizes that when supervening circumstances lead to a fundamental change in the equilibrium of the contract, relief on the ground of hardship may be available. A few cases have granted relief under this provision, but they are rare. In addition, arbitration panels are divided on the question of whether hardship is part of the general commercial law, the *lex mercatoria*.

Article 79 of the CISG provides for relief due to an "impediment" beyond the control of a party that the party could not reasonably have been expected to take into account. Controversy exists as to whether the concept of impediment encompasses economic hardship due to market change. The paper examines the contending arguments and case law on this issue.

Because both common and international law rarely provide relief from market change, a party who wishes to have protection against market disruptions should provide for this contingency by contract. The final section of the paper, with no intent of being complete, suggests various types of clauses for the parties to consider incorporating into their contracts to deal with market change: whereas clauses; express conditions; MAC (market adverse condition) clauses; expanded force majeure clauses; hardship clauses; renegotiation and adjustment clauses; choice of law, forum, and arbitration clauses; Take-or-Pay and Hell-or-High-Water clauses. The fundamental message

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of the paper is that the parties should address relief from market changes in the negotiation of the contract. If they choose not to do so, they cannot expect to obtain relief from courts or arbitrators.

KEYWORDS: contract, impracticability, frustration, *force majeure*, CISG, UNIDROIT Principles, drafting, market change, economic crisis, hardship, MAC clauses, renegotiation, economic duress, international contract law, price adjustment, Take-or-Pay clauses, Hell-or-High-Water clauses

I. Common Law and UCC Principles on Whether Significant Market Change is a Basis for Avoidance or Modification of Contractual Liability.

A claim that a contract can be avoided because of fundamental market changes can arise in a number of different ways. The most common way is by a claim that the contract has been rendered commercially impracticable, i.e. fundamentally more difficult or expensive to perform even if such performance would not be impossible. A second type of claim is when a *force majeure* provision contained in the contract which covers major market changes relieves a party from its contractual obligations. Finally, in some cases market changes can give one party to a contract enormous economic power over the other party. That power can lead to coerced modifications. The weaker party may later attempt to avoid the contract because of duress. This section considers cases dealing with market change in all of these situations.

The basic theme that emerges from the case law is that major market changes are rarely, if ever, the basis of avoidance of a contractual obligation. The penultimate part of this section deals with the Restatement and UCC provisions that reflect this basic principle, sometimes referred to in the paper as the "principle of market risk." The final part of this section considers recent cases that have applied the market risk principle in the context of the current economic crisis.

A. Whether dramatic market changes can make performance commercially impracticable.

A leading case dealing with whether a party can obtain relief from enforcement of a contract on the ground of commercial impracticability when dramatic market change makes performance substantially more expensive or substantially less valuable is *Karl Wendt Farm Equipment Co. v. International Harvester Co*.[1] Wendt (plaintiff) and International Harvester Co. (defendant) entered into a contract in which Wendt was a dealer in Michigan of goods made by IH. Years later, there was a dramatic recession in the farm equipment market and IH had substantial losses, in the amount of approximately $1 million per day. IH faced the possibility of bankruptcy unless it could stop these dramatic losses. IH, therefore, sold its farm equipment division to a competitor (Case/Tenneco) that already had its own dealers in Michigan, and Wendt was not offered a franchise. Wendt sued alleging breach of IH's Dealer Agreement.

[1] 931 F.2d 1112 (6th Cir. 1991).

The Sixth Circuit found for the plaintiff. Reversing the trial court that had found impracticability of performance on the facts of the case, the appellate court held that impracticability of performance was a valid defense, but it was not applicable on these facts. In particular, the court held that to invoke impracticability you have to show a failure of a basic assumption on which the contract was based. However, stability of the market is not a valid assumption because markets are subject to dramatic changes. The Sixth Circuit also denied that mutual profitability could be viewed as the primary purpose of the contract and as a way to rescind or void the contract due to frustration of purpose. The court rejected IH's frustration argument for two reasons. First, section 1 of the contract set forth the purposes of the agreement, and mutual profitability was not mentioned. Second, frustration is an equitable doctrine designed to fairly apportion unforeseen risks. The court recognized that IH might have valid economic reasons for going out of the farm equipment business, but fairness did not require allocation of this risk to the dealers.[2]

B. Whether a *force majeure* clause can be used to avoid a contract because of dramatic market change.

Contracts often contain *force majeure* clauses. The purpose of such clauses is to allow a party to avoid a contract even when doctrines such as impossibility or impracticability do not provide relief. The typical clause specifies various events, such as war, acts of God, or strikes, as grounds for contractual excuse. If a *force majeure* clause is narrowly drafted, a court is almost certain not to apply it to market change. For example, in *United States v. Panhandle Eastern Corp.*,[3] the court dealt with a natural gas supply contract. The buyer claimed that it should be relieved of its obligations under the contract because of market fluctuations and revocation of the buyer's import license. The *force majeure* clause in that case stated that the parties would be temporarily relieved of their obligations under the contract "in cases of *force majeure* or chance events affecting the facilities used for the performance of this Contract, such as in particular [listing of typical *force majeure* events]." The court found that the clause did not cover adverse market or economic conditions.[4]

However, even when the *force majeure* clause is quite broad, courts are unlikely to construe the clause to cover market changes. In *Northern Indiana Public Service Co. v. Carbon County Coal Co.*,[5] the plaintiff, NIPSCO, entered

[2] Id. at 1119-20.
[3] 693 F. Supp. 88 (D. Del. 1988).
[4] Id. at 96.
[5] 799 F.2d 265 (7th Cir. 1986).

into a long term contract to purchase 1.5 million tons of coal each year at prices subject to escalation. The price had risen from $24 per ton to $44 per ton. NIPSCO brought suit for a declaratory judgment that it was relieved of its obligations under the contract by *force majeure*. The *force majeure* clause in that case stated that NIPSCO could stop taking delivery "for any cause beyond [its] control . . . including but not limited to . . . orders or acts of civil . . . authority . . . which wholly or partly prevent . . . the utilizing of the coal."[6] Writing for the court Judge Posner stated:

> A *force majeure* clause is not intended to buffer a party against the normal risks of a contract. The normal risk of a fixed-price contract is that the market price will change. If it rises, the buyer gains at the expense of the seller (except insofar as escalator provisions give the seller some protection); if it falls, as here, the seller gains at the expense of the buyer. The whole purpose of a fixed-price contract is to allocate risk in this way. A *force majeure* clause interpreted to excuse the buyer from the consequences of the risk he expressly assumed would nullify a central term of the contract.[7]

The Fourth Circuit reached a similar conclusion in *Langham-Hill Petroleum, Inc. v. Southern Fuels Co.*[8] The *force majeure* clause in that question applied to events "outside Southern's control." The court concluded that an inability to buy at favorable prices was not an event outside a buyer's control.

Even more specific clauses that refer to market failure would probably not be sufficient to relieve a party of a contractual obligation due to substantial market changes. In *Golsen v. ONG Western, Inc.*,[9] the plaintiff (seller) sued the buyers for failure to pay for gas under a "take-or-pay" supply agreement. The defendant claimed that it suffered a dramatic loss of demand for gas and that under the *force majeure* clause of the contract, it was relieved of its obligation to pay for the gas. The lengthy *force majeure* clause in that case included "failure of market" as a ground for *force majeure.*[10] However, the Oklahoma Supreme Court rejected the argument. The court held that the contract must be read as a whole, and the three words in the *force majeure* clause referring to failure of market could not override the other provisions of the contract, particularly the take-or-pay provision.[11]

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[6] Id. at 274.
[7] Id. at 275.
[8] 813 F.2d 1327 (4th Cir. 1987).
[9] 756 P.2d 1209 (Okla. 1988).
[10] Id. at 1211.
[11] Id. at 1213-1214.

C. Economic duress as a defense against enforcement of a contract when the market changes dramatically.

Because of market changes, a party might find itself in the position to dictate to the other party extremely unfavorable conditions. For example, a supplier might impose a dramatic price increase on a buyer who needs a certain product. In the common law, this is not automatically enough to render the contract voidable. *Cabot Corporation v. AVX Corporation*[12] dealt with the enforceability of a long-term supply contract entered after a dramatic market change. AVX is one of the largest manufacturers and sellers of tantalum capacitors in the world. Cabot is a supplier of tantalum, which is necessary to manufacture the capacitors. The market for tantalum has been highly volatile, sometimes favoring buyers and sometimes favoring sellers. For a number of years preceding the 2000 contract between the parties, the market favored buyers, and AVX was able to purchase tantalum at favorable prices. Each year the parties signed letters of intent setting forth AVX's anticipated needs and agreed-on prices. AVX contended these letters were binding contracts, while Cabot claimed that they were for planning purposes only. In January 2000 the parties signed two letters of intent for 2000 and 2001.

At the end of 2000 a worldwide shortage of tantalum developed. In August 2000 Cabot told its customers that it would limit its supply to those customers who agreed to long-term supply contracts. Between August and November 2000 Cabot and AVX negotiated over the terms of a long-term contract. AVX claimed that Cabot threatened not to supply tantalum under the two letters of intent unless AVX signed a long-term contract. In January 2001 the parties entered into a five-year contract. The prices agreed to were no higher than the current market prices for tantalum powder. Cabot also agreed to AVX's demand for a "most favored customer" pricing clause.

In July 2002, approximately 20 months after the parties entered into the supply contract, AVX brought suit claiming that the contract was the result of economic duress. The Massachusetts Supreme Court rejected the claim of economic duress. The court recognized that Cabot had a superior bargaining position with regard to the 2001 contract but rejected the claim that this amounted to economic duress: "[T]he strength of Cabot's bargaining position in negotiating the supply contract, as well as AVX's weakened position, were the result of a worldwide shortage of the rare tantalum product. . . ."[13] The case stands for the proposition that a party's use of increased bargaining power resulting from dramatic changes in the market does not amount to economic duress.

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[12] 863 N.E.2d 503 (Mass. 2007).
[13] Id. at 512.

D. <u>Restatement and UCC provisions on the effect of market change on contractual obligations.</u>

Both the Restatement of Contracts and the Uniform Commercial Code are consistent with the case law: even a dramatic market change is not generally a ground for avoiding a contract.

Restatement (Second) of Contract §261 provides:

> Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.

Comment b, explaining what a basic assumption is, specifies that:

> The continuation of existing market conditions and of the financial situation of the parties are ordinarily not such assumptions, so that mere market shifts or financial inability do not usually effect discharge under the rule stated in this Section. In borderline cases this criterion is sufficiently flexible to take account of factors that bear on a just allocation of risk. The fact that the event was foreseeable, or even foreseen, does not necessarily compel a conclusion that its non-occurrence was not a basic assumption.

The UCC agrees with the basic principle that even dramatic market change is not generally a ground for avoiding a contract. Only if the market change rises to the level of impracticability can the affected party have relief from the occurrence of the contingency and only if the contingency in question "was a basic assumption on which the contract was made."

UCC 2-615(a) states:

> Delay in delivery or non-delivery in whole or in part by a seller who 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 any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.

Official comment 4 is specific about the effect of market change on contractual obligations:

> Increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance. Neither is a rise or a collapse in the market in itself a justification, for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover.

A case citing with approval the provisions of both the Restatement and the UCC dealing with the effect of market change on contractual obligations is *Lawrence v. Elmore Bean Warehouse, Inc.*[14] In *Lawrence* Elmore Bean agreed to purchase pinto beans from Lawrence at a fixed price. After the market price dropped dramatically, the purchaser attempted to avoid the contract on the ground of commercial impracticability. Citing the comment 4 to UCC §2-615 and comment b to Restatement §261, the court rejected the purchaser's defense, stating: "Shifting and changing market conditions appear to be the norm of the business world. Therefore, more often than not they are foreseeable."[15]

E. <u>Application of the market risk principle to the Great Recession.</u>

The Great Recession that began in 2007 has been an economic disruption of a degree only exceeded by the Great Depression of the 1930s. Could the severity of this economic disruption change the basic principle of assumption of market risk discussed in the preceding sections? It seems not. In *Ner Tamid Congregation of North Town v. Krivoruchko,*[16] Krivoruchko agreed to purchase property held by the Ner Tamid Congregation for a purchase price of $3.4 million. The purchase was not subject to a financing contingency. Krivoruchko attempted to avoid the contract on the grounds of impossibility and impracticability claiming that he could not obtain financing for the purchase. He argued that "the depth" of the real estate recession that began in 2007 was neither foreseen nor foreseeable by him. The court cited a number of articles and books that, particularly after 2005, discussed the existence of a housing bubble.[17] The court concluded that the risk of a real estate downturn may have been uncertain but it was not unforeseeable.[18]

[14] 702 P.2d 930 (Idaho Ct. App. 1985).
[15] Id. at 932.
[16] 638 F. Supp.2d 913 (N.D. Ill. 2009).
[17] Id. at 925-927.
[18] Id. at. 927.

Moreover, Krivoruchko assumed the risk that financing might not be available by failing to include a financing contingency clause in the agreement.[19]

Another Great-Recession case is *Alliant Tax Credit Fund 31-a, Ltd. v. Taylor 8 Assoc., LLC.*[20] In that case the parties were partners involved in providing low and moderate income housing. Under the partnership agreement Taylor 8 was required to convert construction loans to permanent financing. Because Taylor 8 failed to do so, the plaintiff brought suit to have it removed as a general partner. Taylor 8 claimed that the failure to convert was not its fault and that it should be excused from any breach under the doctrines of impossibility or impracticability. Taylor 8 claimed that the dramatic decline in the real estate market caused its lender, Bank of America, to become reluctant to close loans that the bank had agreed to make to the partnership. Bank of America "engaged in an ongoing pattern of asserting ever-changing demands that were vague, unreasonable, untimely and impossible to achieve."[21] Citing comment b to Restatement §261 (quoted above) as well as the language of the agreement, the court rejected the defense, finding that Bank of America's failure to close the loan was foreseeable and was a market risk that Taylor 8 assumed.[22]

Twin Holdings of Delaware LLC v. CW Capital, LLC[23] is another case arising from the recent economic crisis. The court found that the parties were

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[19] Id. at 928.

[20] 2009 WL 691900 (E.D. Mich. 2009).

[21] Id. at *3.

[22] Id.

[23] 2010 WL 309022 (N.Y. Sup. Ct. 2010). The court stated:

> . . . Plaintiffs allege that the decline in the real estate market, a factor outside their control, has made it more difficult to lease out space in their building. The complaint may also be read as alleging that the "financial crisis" has made it more difficult for plaintiffs to obtain long term, fixed rate financing in order to pay off the loan made by defendants.
>
> However, because the parties are sophisticated entities with knowledge of the real estate industry, they clearly understood the cyclical nature of the real estate market and could not have assumed that demand for space would not decline. Moreover, they were certainly aware of the possibility of volatility in the financial markets and could not have assumed that banks would not become unwilling to extend credit. The parties' awareness of fluctuations in the financial markets is confirmed by the fact that the note carried a variable interest rate. Thus, the non-occurrence of a decline in the real estate market and tight credit was clearly not a basic assumption on which the loan was made. The seventh cause of action, requesting a declaration that plaintiffs are temporarily excused from performance on the ground of impracticability or frustration, is *dismissed* for failure to state cause of action. 2010 WL 309022 at *5-*6.

But See Bank of America, N.A. v. Shelbourne Development Group, Inc., 2010 WL 3269647 (N.D. Cal. 2010) (denying bank's motion to strike affirmative defense of impossibility because bank had made numerous public statements to the effect that economic downturn was unprecedented, unparalleled, and not reasonably foreseeable). Id. at *14.

sophisticated entities and that they should have known that the real estate market is cyclical. Based on those facts the court denied relief on the basis of impracticability or frustration.

F. Conclusion.

Common law authorities and the UCC are quite uniform in their approach to the question of whether dramatic market change can relieve a party of its contractual obligations. The answer, regardless of the theory used to seek relief, is practically never.

II. The Effect of Market Change on Contracts Governed by International Contract Principles.

It is difficult to analyze the effect of market change on international contracts because there is no single set of principles that governs the issue. International contracts frequently have a choice of law provision. Often the choice of law provision will be that of a U.S. state, such as New York. In that situation, an analysis of New York law (or the law of whichever jurisdiction is chosen) would be necessary. Such an analysis, while important in individual contracts, is beyond the scope of this paper. This section focuses on two bodies of international contract law: the UNIDROIT Principles and the Convention on the International Sale of Goods (the CISG).

The International Institute for the Unification of Private Law (UNIDROIT) is a private intergovernmental organization seated in Rome.[24] The Institute has 63 member nations.[25] The purpose of the Institute is "to study needs and methods for modernizing, harmonizing and coordinating private and in particular commercial law as between States and groups of States."[26] In 1994 the Institute issued Principles of International Commercial Contracts. The Principles were revised and expanded in 2004.[27] The UNIDROIT Principles do not have the force of law, but as set forth in the Preamble to the Principles, they can be used in various ways. First, the Principles can be applied when the parties have agreed that their contract will be governed by the Principles. Second, tribunals can apply the Principles when the contract states that it will be governed by general principles or the *lex mercatoria*. Third, tribunals can apply the Principles when the contract does not have a choice of law clause. Fourth, the

[24] http://www.unidroit.org/dynasite.cfm?dsmid=103284.

[25] For a list of member nations see http://www.unidroit.org/english/members/main.htm.

[26] See note 24 *supra*.

[27] For the text of the principles see http://www.unidroit.org/english/principles/contracts/main.htm.

Principles can supplement applicable law. Finally, the Principles can be used by law makers, contract drafters, and contract negotiators.[28]

The Preamble to the Principles gives examples of choice of law clauses that drafters could use. If parties want to provide that the Principles govern any disputes arising under the agreement, they can use the following choice of law clause with desired exceptions or modifications. "This contract shall be governed by the UNIDROIT Principles (2004)[except as to the Articles...]." Parties that wish to supplement the Principles with the law of a particular jurisdiction (New York for example) could use the following clause: "This contract shall be governed by the UNIDROIT Principles (2004)[except as to Articles...], supplemented when necessary by the law of New York."

A. The effect of market change on contracts under the UNIDROIT Principles.

Article 6.2.1 of the UNIDROIT Principles recognizes the general rule that a party is bound to the terms of the contract even if it becomes more onerous. The following example -- given in Article 6.2.1 itself -- illustrates the principle:

> In January 1990 A, a forwarding agent, enters into a two-year shipping contract with B, a carrier. Under the contract B is bound to ship certain goods from Hamburg to New York at a fixed price, on a monthly basis throughout the two-year period. Alleging a substantial increase in the price of fuel in the aftermath of the 1990 Gulf crisis, B requests a five per cent increase in the rate for August 1990. B is not entitled to such an increase because B bears the risk of its performance becoming more onerous.

However, Article 6.2.1 recognizes that in exceptional cases relief may be granted under the principle of hardship, when supervening circumstances lead to a fundamental change in the equilibrium of the contract.[29] The comments note that many countries recognize the concept of hardship as a basis for granting relief from the obligations of a contract.[30]

Article 6.2.2 of the Principles defines the concept of hardship more precisely:

[28] See UNIDROIT Principles, Preamble, http://www.unidroit.org/english/principles/contracts/main.htm.
[29] UNIDROIT, Principles of International Commercial Contracts, Article 6.2.1, comment 2 (2004 ed.), http://www.unidroit.org/english/principles/contracts/principles1994/1994fulltext-english.pdf.
[30] Id.

> There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and
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> (a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
> (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
> (c) the events are beyond the control of the disadvantaged party; and
> (d) the risk of the events was not assumed by the disadvantaged party.

Severe changes in the market are one way in which the equilibrium of a contract can be fundamentally altered. Because of market charges, the cost of a party's performance can be increased or the value of the performance a party receives diminished. The comments to Article 6.2.2 are quite clear that a major market change may be the basis of relief. Comment 2(a) refers to a "dramatic rise in the price of raw materials." Comment 2(b) mentions "drastic changes in market conditions."

Of course, the fact that the equilibrium of the contract may have been fundamentally altered does not mean that a party will be able to obtain relief on the ground of hardship. In addition, the party must show that the events occurred after the contract was entered into, that the disadvantaged party could not reasonably have taken the events into account, the events are beyond the control of the disadvantaged party, and the disadvantaged party does not bear the risk of the events. Often changes in market conditions are foreseeable and therefore are not the basis of relief.[31]

A change in the market after the execution of the contract only amounts to hardship if the equilibrium of the contract has been *fundamentally* altered. The requirement of a fundamental alteration of the contract implies that normal economic risks are not to be regarded as hardship, but only developments in the market that lie far beyond standard economic fluctuations can be hardship. The comments to the UNIDROIT Principles state as a guideline in cases of price increases or decreases in the value of performance that an alteration of 50% or

[31] UNIDROIT Principles Article 6.2.2, comment 3(b).

more is likely to be regarded as a fundamental alteration of the equilibrium of the contract.[32] An example of such a situation is the following:

> In a sales contract between A and B the price is expressed in the currency of country X, a currency whose value was already depreciating slowly against other major currencies before the conclusion of the contract. One month afterwards a political crisis in country X leads to a massive devaluation of the order of 80% of its currency. Unless the circumstances indicate otherwise, this constitutes a case of hardship, since such a dramatic acceleration of the loss of value of the currency of country X was not foreseeable.[33]

Article 6.2.3 deals with the remedy for hardship. The existence of hardship does not give rise to a right to avoid the contract, but it does give the disadvantaged party a right to request that the parties renegotiate the contract. Upon failure to reach an agreement, the disadvantaged party can request the court or arbitral tribunal to either terminate or revise ("adapt") the contract.[34]

Recently a Brazilian arbitration tribunal[35] - making reference to Article 6.2.1 of the UNIDROIT Principles to confirm its application of domestic law - found that the mere fact that contract performance entails a higher economic burden for one of the parties does not amount to hardship. In 2006, the plaintiff, a Brazilian energy trader, had entered into a long-term agreement with the defendant, another Brazilian energy trader, whereby the plaintiff would supply the defendant an average of 22 MW of electric energy on a monthly basis from January 1, 2007, through December 31, 2011, and the defendant would pay the plaintiff an agreed price that varied annually. In January 2008, the plaintiff suspended delivery of the power and commenced arbitration proceedings against the defendant, arguing that it had a right to terminate the contract on the grounds of hardship, and claiming damages for having been exposed to the "spot-price" established for short-term energy transactions by the Chamber of Trade on Electric Energy. The plaintiff contended that between January 2007 and January 2008 an extraordinary and unexpected increase in power prices developed in the short-term market affecting the supply agreement entered into with defendant; in substance the plaintiff alleged hardship because of a substantial and unforeseen

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[32] UNIDROIT Principles, Article 6.2.2, comment 2.
[33] Id. illus.3.
[34] UNIDROIT Principles, Article 6.2.3(4)(b).
[35] Delta Comercializadora de Energia Ltda. v. AES Infoenergy Ltda, decided by Câmara FGV de Conciliação e Arbitragem (São Paulo, Brazil), 09.02.2009.

increase in price. The tribunal rejected the claim based on national law and found that the termination of a contract for unforeseen circumstances (hardship) should be allowed "only in truly exceptional circumstances." The tribunal noted that Article 6.2.1 of the UNIDROIT Principles expressly provides that the fact that performance of the contract becomes more onerous for one of the parties is not sufficient to establish "hardship."[36]

Cases involving the hardship provisions of the UNIDROIT Principles typically arise in an arbitration setting. Many of these decisions are unreported or reported without clear discussion of the underlying factual context.[37] A review of these decisions does reveal one significant point: arbitration panels appear to be divided on the question of whether the concept of hardship as expressed in UNIDROIT Principles is part of the *lex mercatoria* or trade custom in international contracts.[38] Therefore, if a party to a contract wants to make sure that the concept of hardship will be applicable, the choice of law provision should make specific reference to the UNIDROIT Principles.[39]

B. Effect of market change on contracts governed by the CISG.

The CISG is an international treaty to which the United States and many other major commercial countries are parties.[40] China and Japan are parties to the CISG; most European countries are parties; however, the U.K. is not.[41] The CISG generally applies to contracts for the sale of goods between parties whose places of business are in different countries that are signatories to the treaty.[42] The CISG applies to contracts for the sale of goods, so it is essentially a

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[36] The attitude of the Brazilian arbitral tribunal is not isolated. In 2006 another arbitration tribunal found that even the destruction of crops by extraordinary rainstorms and flooding was not a case of hardship because the grower typically assumes the risk of occurrence of such meteorological events (Article 6.2.2 UNIDROIT Principles). In addition, according to this tribunal, hardship does not exclude a disadvantaged party's liability for non-performance, but only entitles it to request renegotiation of contract (Article 6.2.3(1) UNIDROIT Principles). Centro de Arbitraje de Mexico (CAM), (November 30, 2006).

[37] See Unilex, UNIDROIT Principles, http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13621&x=1.

[38] See ICC, International Court of Arbitration, #12446 (2004); ICC International Court of Arbitration, Rome, #9029 (1998); ICC, International Court of Arbitration, Paris, #8873 (1997). But see ICC, International Court of Arbitration #9994 (2001) (French law applicable, but tribunal also refers to UNIDROIT Principles); ICC, International Court of Arbitration, #9479 (1999) (contract silent on applicable law; tribunal applies hardship provision of UNIDROIT Principles under "Usages of International Trade").

[39] Centro de Arbitraje de Mexico (CAM) (November 30, 2006).

[40] For the text of the treaty see http://www.cisg.law.pace.edu/cisg/text/treaty.html

[41] For a list of states that have ratified the treaty as of July 7, 2010, see http://www.cisg.law.pace.edu/cisg/countries/cntries.html

[42] CISG Article 1(a). The CISG also applies when the rules of private international law would lead to the application of the law of a Contracting State. Id. Article 1(b).

commercial treaty.[43] Because the CISG is a treaty, it has the force of law in those countries that have adopted it.

Article 79 of the CISG states: "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." There is no indication in the text about what the word "impediment" means; in particular it is not clear whether it only relates to physical impossibilities or if it also encompasses economic impossibilities. As a result an issue arises as to whether hardship in the sense of alteration in the fundamental equilibrium of the contract is applicable under the CISG.

The argument that the CISG does not recognize hardship finds support in the text of the CISG,[44] the legislative history of the CISG,[45] and a limited amount of case law.[46]

First, the text of the CISG does not include a provision on hardship like that found in the UNIDROIT Principles. Moreover, the term "impediment" is found in the Principles under the concept of *force majeure*, which is a distinct concept from hardship.[47]

Second, the legislative history of Article 79 points to the conclusion that the use of the word "impediment" was designed to exclude situations in which the obligor sought to avoid liability because performance had become "unexpectedly difficult for reasons beyond his control."[48] In addition, during the drafting history of the CISG, Norway presented a proposed amendment to Article 79 that would have incorporated to some degree the concept of hardship, but this amendment was not adopted.[49] Rejection of this amendment supports the view that the CISG was not intended to provide relief for hardship.

Third, some courts concluded that Article 79 does not apply to market changes. In 1993 an Italian court found that a seller could not avoid liability under Article 79 when the price of metal subject to the contract had risen so rapidly and unexpectedly that the fundamental equilibrium of the contract had

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[43] CISG Article 2(a).
[44] See text at note 47 *infra*.
[45] See text at notes 48-49 *infra*.
[46] See text at notes 50-52 *infra*.
[47] UNIDROIT Principles, Article 7.1.7(1) and comment 3.
[48] See CISG Advisory Council Opinion #7 (October 12, 2007), at n. 33, http://www.cisg.law.pace.edu/cisg/CISG-AC-op7.html
[49] Id. at ¶30.

been destroyed.[50] However, the decision has been viewed as dictum because the CISG did not apply to the case.[51] Similarly, a German court, also in dictum, held that hardship was not a basis for relief under the CISG, displacing German law, which provided for relief on the ground of hardship, although the report of the decision does not provide the court's reasoning.[52]

Finally, as further support for the nonrecognition of hardship by the CISG, it has been argued that a claim of hardship goes to the *validity* of the contract. Under Article 4(a) of the CISG issues of validity (which are distinguished from grounds for relief of a contractual obligation) are specifically excluded from the CISG.[53]

While these arguments to exclude hardship as a defense against performance of a contract subject to the CISG have some merit, they fail to establish that hardship should not be applicable to cases governed by the CISG. First, the argument based on the text of the CISG is weak because the CISG does not define the term "impediment." If the drafters had intended to limit the term to cases of physical impossibility, then it would have been easy to say so. Thus, it is open to interpretation whether the term impediment covers extreme economic difficulty. As shown below recent authorities seem to support the view that a defense of hardship may be raised under the CISG.

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[50] Nuova Fucinati, S.p.A. v. Fondmetall International A.B., Tribunale di Monza, Italy, 14 January 1993, reproduced in English translation 15 J.L. & Com. 153 (1995), available at <http://cisgw3.law.pace.edu/cases/930114i3.html>. The plaintiff, an Italian seller who failed to deliver the goods to the defendant, a Swedish buyer, claimed avoidance of the sales contract on the ground of hardship since the price of the goods had increased after conclusion of the contract and before delivery by almost 30%. The court found that the CISG was not applicable because Sweden (the country of the buyer) had not ratified the CISG before the execution of the contract and therefore Italian law (the law chosen by the parties) was applicable. Under article 1467 Italian Civil Code when one party's performance has become excessively burdensome because of an extraordinary and unexpected event, the affected party can ask for the rescission of the contract. The other party can avoid the rescission by offering the so called "*reductio ad equitatem,*" i.e. a modification of the contract. However, the court held that the remedy of article 1467 was not available to Nuova Fucinati (seller) because, under the facts of the case, no extraordinary and unexpected event had happened. The *Nuova Fucinati* decision is part of the majority trend in Italian courts holding that an increase in market price can rarely justify the remedy of article 1467 Civil Code because the increase in the market price is almost never an "extraordinary and unexpected event," unless the measure of increase is outside the range of prediction of the average person (e.g. Corte di Cassazione 4 March 2004 no. 4423; Corte di Cassazione 25 March 1987 no. 2904, holding that no article 1467 remedy can be granted based on ordinary fluctuation of the value of the performances; Corte di Cassazione 13 February 1995 no. 1559, holding that sometimes the fluctuation of the value of the performances can be the basis of an article 1467 remedy but only when the measure of the fluctuation is outside of the possibility of prediction of the average man).

[51] See id. See also CISG Advisory Council Opinion #7 (October 12, 2007), at n. 41, http://www.cisg.law.pace.edu/cisg/CISG-AC-op7.html.

[52] Id. at ¶31.

[53] Id. at ¶36.

Similarly, the legislative history of Article 79 is not clear enough on the issue of the applicability of hardship to CISG cases. As one authority stated:

> Speculation about what the intention of the drafting group might have been with regard to the scope of application of CISG Article 79 is unlikely to be too accurate, especially when we are left to our inferences from fragments in the *travaux préparatoires*. Indeed, the dismissal of a proposal which did not even address whether hardship should be given any space within the Convention is no proper foundation upon which to build an argument on the "intention of the legislator."[54]

The argument that the CISG excludes claims about the validity of the contract does not seem particularly persuasive with regard to the claim of hardship. Validity claims typically arise at the time the contract was formed -- fraud for example. Hardship arises from subsequent events. In addition, unlike claims of invalidity, hardship does not give rise to a right to terminate the contract.[55]

Most importantly, recent authorities accept the view that hardship can be an impediment under Article 79. In 2007 the CISG Advisory Council[56] issued Opinion #7 on the scope of Article 79.[57] Section 3.1 of the Opinion adopts a broad view of Article 79:

> A change of circumstances that could not reasonably be expected to have been taken into account, rendering performance excessively onerous ("hardship"), may qualify as an "impediment" under Article 79(1). The language of Article 79 does not expressly equate the term "impediment" with an event that makes performance absolutely impossible. Therefore, a party that finds itself in a situation of hardship may invoke hardship as an exemption from liability under Article 79.

In *Scafom International BV v. Lorraine Tubes s.a.s.*,[58] the court recognized that the UNIDROIT concept of hardship could be applied in a contract

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[54] Id. at n.39.

[55] Id. ¶36 (rejecting the validity argument).

[56] The CISG Advisory Council is not an official body and does not issue binding interpretations. It was created by Pace University, which houses an extensive website on the CISG. See http://www.cisgac.com/default.php?sid=149.

[57] http://www.cisg.law.pace.edu/cisg/CISG-AC-op7.html.

[58] 9.06.2009 Court of Cassation of Belgium, C.07.0289.N.

subject to the CISG. The contract in that case was for the sale of steel tubes between a Dutch Company and a French company and was governed by the CISG. The price of the tubes increased by 70% of the contract price. The seller invoked hardship under the UNIDROIT principles and requested renegotiation of the contract price. The court found that the CISG was silent on hardship, and that the gap was to be filled in accordance with Article 7(2) of the CISG.[59] The seller's right to re-negotiation was affirmed. The court referenced general principles governing the law of international commerce, including the UNIDROIT Principles.

Of course, even if a tribunal recognizes that the concept of hardship applies to the cases governed by the CISG, relief will not be easy to obtain. In 2001, a French court decided a case involving a Swiss buyer (defendant) and a French supplier (plaintiff). The plaintiff-seller agreed, for a fixed price, to deliver at least 20,000 crankcases over eight years according to the needs of the defendant's client, a truck manufacturer. Following a sudden collapse in the automobile market, the truck manufacturer imposed on the defendant a price which was fifty per cent lower than the price of the incorporated components sold by the plaintiff; therefore, the defendant communicated to the plaintiff its intention not to buy any more crankcases from plaintiff. Nonetheless, the seller sent almost half of the 20,000 units. The plaintiff brought an action for breach of contract. The Court of Appeal, reversing the trial court, found that the CISG applied but rejected the defendant's impediment argument under Article 79. The court reasoned that even if significant modification of the terms of purchase by the defendant's client could be found to constitute grounds for exemption under Article 79, in this case the modification, which made it very costly for the defendant to continue incorporating components produced by the plaintiff, was neither exceptional nor unforeseeable in a contract whose duration was fixed at eight years. The court observed that the defendant was a "professional experienced in international market practice," and therefore should have protected itself by appropriate contractual provisions.[60]

In accord with this French decision is another case of 2002 concerning an international contract for the sale of pork. The District Court of Ieper (Belgium) held that defendant could not rely on altered economic circumstances to escape its contractual obligations.[61]

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[59] Article 7(2) CISG: "Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law."

[60] Société Romay AG v. SARL Behr France, 12 June 2001 Appellate Court Colmar (France), http://cisgw3.law.pace.edu/cases/010612f1.html.

[61] February 18 2002 *L. v. SA C.*, http://cisgw3.law.pace.edu/cases/020218b1.html.

III. Drafting Clauses to Provide Relief for Significant Market Changes.

Very rarely, if ever, does the common law allow parties to avoid contracts because of market changes.[62] In addition, a standard *force majeure* clause will rarely provide protection against significant market changes, and a detailed clause with a reference to market failure is likely to be narrowly construed.

The international practice seems more receptive to a grant of relief due to significant market changes because in some cases market change -- when it amounts to hardship -- has been the basis for relief.[63] Nevertheless as a matter of principle, also in the international context, there is often no relief if the event was foreseeable at the time of execution of the contract, and the fluctuation of the market generally is foreseeable.

Accordingly, a party who wishes to have protection against market changes should carefully draft appropriate contractual provisions. However, there are various ways in which this issue can be approached. This section, while it does not attempt to provide a complete analysis of drafting alternatives, considers some of the drafting solutions available to the parties following the structure of a standard agreement. The section concludes with discussion of clauses that parties can use to exclude the effect of market change.

A. Use of whereas clauses to express the parties' intent.

Since the common law presumes that the parties to a contract assume risks and should bear whatever market change occurs, a "whereas" clause could be used to make it clear and evident that the intent of the parties was, for example, to allow a party to avoid the contract when substantial market change occurs (for example, a change of 50%, which is the threshold for hardship in the UNIDROIT Principles).[64] The clause should serve as an interpretation guide in construing the contract.[65] Of course, a "whereas" clause by itself cannot be the basis for relief; to allow this you need a substantive clause providing relief for hardship, as discussed below. Nevertheless, appropriate language in a "whereas" clause with regard to market change is useful to show the intent of the parties.

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[62] See Part I *supra*.
[63] See Part II *supra*.
[64] UNIDROIT Principles, Article 6.2.2, comment 2.
[65] This is an example of the use of the Principles by contract drafters. See text at note 28 *supra*.

B. Use of express conditions.

The general common law rule is that strict compliance with an express condition is necessary,[66] unless the condition has been excused on some ground such as waiver by the party benefited by the condition or forfeiture as a matter of law.[67] The UNIDROIT Principles do not have a specific section on express conditions, but various articles state that parties must comply with their contractual obligations[68] unless some grounds for relief exists.[69] The CISG is similar.[70]

Thus, parties could use the concept of an express condition to provide for relief against market change. For example, the contract might provide as follows:

> *Right of Cancellation Due to Substantial Market Change.* The parties intend and agree that continuation of the market within its normal, historical range is an express condition of each party's duty to perform the contract. If the market price for [commodity or service] increases or decreases by more than 50% from the market price on the day of execution of this contract, which the parties agree is [insert market price], then the disadvantaged party shall have the right to cancel the contract. This right must be exercised -- by written notice to the other party -- within 30 days after the date on which the market price reaches the level of a 50% increase or decrease as the case may be. The notice will be effective after 15 days from the date of reception.

Because of the common law principle that express conditions can be excused to avoid forfeiture,[71] it would be wise to include language in the drafting of the express condition indicating the intention of the parties that the hardship provision not be excused to avoid forfeiture. For example, the following sentence could be added to the above clause:

> The parties intend that this express condition is strictly enforceable and, therefore, a party cannot seek to avoid the application of this

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[66] See Oppenheimer & Co. v. Oppenheim, Appel, Dixon & Co., 660 N.E.2d 415 (N.Y. 1995).

[67] Restatement (Second) of Contracts §§84 (waiver), 229 (forfeiture).

[68] See UNIDROIT Principles Articles 5.1.1-5.1.9. For example, Article 5.1.4(1) states that to the extent the contract requires a party to achieve a specific result, the party must do so. Article 5.1.6 provides that the quality of performance under a contract is determined by the terms of the contract.

[69] Id. Article 6.2.2 on hardship, discussed in Part II above.

[70] CISG Article 30 (seller must deliver goods or documents as required by the contract); CISG Article 53 (buyer must pay the price and take delivery as required by the contract).

[71] Restatement (Second) of Contracts §229.

> condition on the basis of forfeiture or other grounds for excuse of condition. This condition is subject to elimination or modification only by express written agreement of the parties.

While the parties might choose to provide for a right of cancellation, a different remedy for hardship can be agreed between the parties. For example, based on the model of the UNIDROIT Principle of Hardship, also in a domestic context, the clause could trigger a right to renegotiation.[72] If renegotiation were unsuccessful, the disadvantaged party could seek relief in court; this could include the right of a court to adjust the contract to take into account new market conditions.[73] For example, the clause might read as follows:

> *Rights of the Parties in the Event of Substantial Market Change.* The parties intend and agree that continuation of the market within its normal, historical range is an express condition of each party's duty to perform the contract. If the market price for [commodity or service] increases or decreases by more than 50% from the market price on the day of execution of this contract, which the parties agree is [insert market price], then the disadvantaged party shall have the right to request renegotiation. This right must be exercised within 30 days after the date on which the market price reaches the level of a 50% increase or decrease as the case may be on written notice to the other party. If the parties fail to reach agreement on renegotiation of the contract within 60 days after the demand for renegotiation, then either party may resort to court. The court may either (1) terminate the contract at a date on terms to be fixed or (2) adjust the price to the extent the court considers just.[74]

If the parties were uncomfortable with the possibility of court adjustment, the contract could provide a right of rescission by either party after the court's adjustment. At the end of the clause above, the parties can add the following language: "If the court decides to adjust the price, either party that is dissatisfied

[72] UNIDROIT Principles Article 6.2.3.

[73] Id. Article 6.2.3(4)(b) (court may adapt the contract to restore equilibrium).

[74] For an example of a case in which a court readjusted a contract when the price formula used by the parties failed to reflect historical price changes, see Aluminum Co. of America v. Essex Group, Inc., 499 F. Supp. 53 (W.D. Pa. 1980). See also John Dawson, *Judicial Revision of Frustrated Contracts: The United States*, 64 B.U.L. Rev. 1 (1984); Richard E. Speidel, *Court-Imposed Price Adjustments under Long-Term Supply Contracts*, 76 Nw. U. L. Rev. 369 (1981).

with the adjustment has the right to cancel the contract on written notice to the other party. The notice will be effective 15 days after the reception."

C. MAC (market adverse condition) clauses.

A materially adverse condition (MAC) clause (also called a material adverse event/effect or MAE clause) is a way for parties to allocate risk presented by adverse business or economic developments. MAC clauses are commonly used in the context of mergers and acquisitions to allocate risk between buyers and sellers in case an adverse business or economic development occurs between signing and closing. MAC clauses are also common in derivative contracts and interest rate swaps. A MAC clause generally refers to a defined term in an agreement delineating what constitutes a material adverse change or a material adverse event/effect. A MAC clause is usually not a basis for immediate termination of a contract unless expressly provided. Normally, only where the affected party has failed to provide adequate performance assurance after receiving a written notice and sufficient opportunity to preserve the integrity of a transaction does a MAC clause entitle the other party to terminate the contract.[75]

However, while mergers, acquisitions, and derivative contracts are the usual setting, a MAC clause could be used in other contexts, like a sale of goods. In a merger or acquisition contract, a MAC clause enables the acquirer to refuse to complete the acquisition or merger if the target suffers such a material change. In a sale of goods contract the MAC clause could provide for a right of termination by the affected party. In the alternative the clause could provide the same right that the UNIDROIT Principles allow in case of hardship: renegotiation of terms and, in case the negotiations are unsuccessful, a right to apply to court for adjustment (or to cancel the contract).

Here is a typical MAC clause (example taken from the agreement by Bank of America to acquire Merrill Lynch[76]):

[75] For a general discussion of MAC clauses see 2 Timothy R. Donovan & Jodi A. Simala, Successful Partnering between Inside and Outside Counsel §41.32 (2010) (available on Westlaw).

[76] This clause was the subject of a dispute regarding Bank of America's acquisition of Merrill Lynch during the financial crisis. According to the Financial Times of London, June 11, 2009, Ken Lewis, CEO of Bank of America, threatened to use a MAC clause to cancel the agreement to buy Merrill Lynch because he felt that Merrill Lynch had declined substantially in value and he wanted to get a lower price. A committee of the U.S. House of Representatives investigated whether or not undue pressure was put on Lewis to complete the deal to purchase Merrill Lynch. Reportedly, Lewis dropped the threat only after former U.S. Treasury Secretary Hank Paulson told him that regulators (including Federal Reserve Board Chairman Ben Bernanke) would remove both Lewis and his board if they tried to invoke the MAC clause. The deal closed in January 2009, but Bank of America has revealed that the deal only went through after Paulson promised $20 billion in taxpayer support. For a discussion of whether Bank of America could have invoked the MAC clause see

> "*Material Adverse Effect*" means a material adverse effect on (i) the financial condition, results of operations or business of such party and its Subsidiaries taken as a whole (provided, however, that, with respect to this clause (i), a "Material Adverse Effect" shall not be deemed to include effects to the extent resulting from (A) changes, after the date hereof, in GAAP or regulatory accounting requirements applicable generally to companies in the industries in which such party and its Subsidiaries operate, (B) changes, after the date hereof, in laws, rules or regulations of general applicability to companies in the industries in which such party and its Subsidiaries operate, (C) actions or omissions taken with the prior written consent of the other party, (D) changes, after the date hereof, in global or national political conditions or general economic or market conditions generally affecting other companies in the industries in which such party and its Subsidiaries operate or (E) the public disclosure of this Agreement or the transactions contemplated hereby, except, with respect to clauses (A) and (B), to the extent that the effects of such change are disproportionately adverse to the financial condition, results of operations or business of such party and its Subsidiaries, taken as a whole, as compared to other companies in the industry in which such party and its Subsidiaries operate) or (ii) the ability of such party to timely consummate the transactions contemplated by this Agreement.

Note that in this formulation, market change is expressly excluded as a material adverse condition. Therefore, a clause like this one would not provide relief to a party in case of market disruptions.

Moreover, courts tend to narrowly construe MAC clauses. For example, in *In Re: IBP, Inc. Shareholders Litigation*[77] a merger agreement contained a broad MAC clause with no carve-outs. Tyson Foods, the buyer, asserted that IBP, the target, had suffered a material adverse effect because its first quarter 2001 earnings were 64 percent behind those for the first quarter of 2000. However, the Delaware Court of Chancery did not regard this downturn as affecting IBP on a long-term basis. A party seeking to invoke a MAC clause and to terminate a deal faces the high burden of proving that the events claimed to be a MAC

Edward Harrison, Trouble looms for Lewis at annual meeting with MAC clause top of mind, http://www.nakedcapitalism.com/2009/04.

[77] 789 A.2d. 14 (Del. Ch. 2001).

"substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the [MAC] should be material when viewed from the longer-term perspective of a reasonable acquirer." The court determined that IBP had not suffered a MAC, and, as a result, Tyson Foods was forced to complete the purchase.[78]

These examples demonstrate that, in drafting the MAC clause, the adverse market change must be specifically included. For example, taking as a model the Bank of America MAC clause, the language of exclusion (D) could be eliminated and the following language could be added: "A material adverse effect includes changes, after the date hereof, in global or national political conditions or general economic or market conditions that materially affect the financial condition of a party regardless of whether these conditions generally affect other companies in the industries in which such party and its Subsidiaries operate."

The following is a possible formulation of a MAC clause that covers market change:

> *"Material Adverse Effect"* means a Material Adverse Effect on (i) the financial condition, results of operations or business of a party and its Subsidiaries taken as a whole; or (ii) the ability of such party to timely consummate the transactions contemplated by this Agreement; *provided however* that "Material Adverse Effect" shall not be deemed to include effects to the extent resulting from (A) changes, after the date hereof, in GAAP or regulatory accounting requirements applicable generally to companies in the industries in which such party and its Subsidiaries operate, (B) changes, after

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[78] See also Frontier Oil Corp. v. Holly Corp,. C.A. No. 20502 (Del. Ch. Apr. 29, 2005). The decision, which embraces the standard set forth in *IBP* as Delaware law, also demonstrates the importance of carefully crafting MAC clauses. The court noted that the phrase "would have" or "would reasonably be expected to have" a MAC, as used in the agreement at issue, created an objective test with a significantly higher threshold than the wording "could" or "might." This standard requires a buyer to examine not only current conditions but also the future, and to produce evidence of a long-term downturn. Another case dealing with the interpretation of a MAC clause is Genesco, Inc. v. The Finish Line, Inc. (unreported). Genesco filed suit against The Finish Line Inc. and Headwind Inc. seeking specific performance of a merger agreement under which The Finish Line was to acquire Genesco. In December 2007, the court granted specific performance, ordering The Finish Line to complete the merger. Although the court found that a MAC had occurred with regard to Genesco's financial condition, the court held that its financial decline fit within a carve-out to the MAC clause contained in the merger agreement, since the decline was due to "general economic conditions" and was not "disproportionate to the financial decline of others in its industry". For a discussion of the case, see In Dispute: Genesco, Inc./The Finish Line, Inc., http://us.practicallaw.com/0-385-3647.

> the date hereof, in laws, rules or regulations of general applicability to companies in the industries in which such party and its Subsidiaries operate, (C) actions or omissions taken with the prior written consent of the other party (D) the public disclosure of this Agreement or the transactions contemplated hereby, except, with respect to clauses (A) and (B), to the extent that the effects of such change are disproportionately adverse to the financial condition, results of operations or business of such party and its Subsidiaries, taken as a whole, as compared to other companies in the industry in which such party and its Subsidiaries operate. The parties acknowledge that a material adverse effect includes changes, after the date hereof, in global or national political conditions or general economic or market conditions that materially affect the financial condition of a party regardless of whether these conditions generally affect other companies in the industries in which such party and its Subsidiaries operate.

D. *Force majeure* clauses.

The following is an example of a typical *force majeure* clause:

> A party is not liable for failure to perform the party's obligations if such failure is as a result of Acts of God (including fire, flood, earthquake, storm, hurricane or other natural disaster), war, invasion, act of foreign enemies, hostilities (regardless of whether war is declared), civil war, rebellion, revolution, insurrection, military or usurped power or confiscation, terrorist activities, nationalization, government sanction, blockage, embargo, labor dispute, strike, lockout or interruption or failure of electricity or telephone service.

The typical *force majeure* clause deals with circumstances that prevent a party from performing, either temporarily or permanently. Viewed this way market change would not fit logically within the framework of a *force majeure* clause. Of course, a standard *force majeure* clause could be expanded to cover market change.

A notation on this point: It might be clearer as a matter of drafting to limit *force majeure* clauses to events that prevent performance, while treating economic hardship separately (either as a condition, a material adverse event, or as the subject matter of a hardship clause). However, there may be a negotiation reason for inserting the hardship provision in the *force majeure* clause. A negotiating official of a company may have policy limitations on the types of clauses that may be included in the contracts he negotiates. A hardship clause might be viewed as an unacceptable addition to the contract, while a modified *force majeure* clause that includes protection against adverse market changes could be viewed as a modest modification of a standard provision.

E. Hardship clauses.

A hardship clause is a clause designed to provide relief due to the creation of an imbalance in contractual obligations. The model for such a clause is Article 6.2.2 of the UNIDROIT Principles, which could be incorporated by a choice of law clause or could be drafted, perhaps with some modifications, into the contract. Express condition causes set forth in part (B) of this section, while they may vary in their wording, are in essence hardship clauses, the only difference being that drafting of the clause as an express condition invokes the principle that express conditions must be strictly performed. For this reason, it would probably be sounder drafting to make the hardship provision an express condition rather than simply a hardship provision.

However, if the parties prefer a hardship clause not to be qualified as an express condition, the following can be viable possibilities.

Solution 1.

> *Right of Cancellation Due to Substantial Market Change.* The Parties stipulate that at the execution of this Agreement the market price for the [commodity or service] is [insert market price]. The Parties acknowledge that they expect that the said market price will not materially change during the term of this Agreement. In case of an increase or decrease of more than 50% from the market price indicated above, the disadvantaged party shall have the right to cancel the contract. This right must be exercised -- by written notice to the other party -- within 30 days after the date on which the market price reaches the level of a 50% increase or decrease as the case may be. The notice will be effective after 15 days from the date of reception.

Solution 2.

> *Rights of the Parties in the Event of Substantial Market Change.* The Parties stipulate that at the execution of this Agreement the market price for the [commodity or service] is [insert market

> price]. The Parties acknowledge that they expect that the market price will not materially change during the term of this Agreement. In case of an increase or decrease of more than 50% from the market price indicated above, the disadvantaged party shall have the right to request renegotiation. This right must be exercised within 30 days after the date on which the market price reaches the level of a 50% increase or decrease as the case may be on written notice to the other party. If the parties fail to reach agreement on renegotiation of the contract within 60 days after the demand for renegotiation, then either party may resort to court. The court may either (1) terminate the contract at a date on terms to be fixed or (2) adjust the price to the extent the court considers just.

If the parties were uncomfortable with the possibility of court adjustment, also in this case the contract could provide a right of rescission by either party after the court's adjustment. At the end of the clause above, the parties can add the following language: "If the court decides to readjust the price, either party that is dissatisfied with the readjustment has the right to cancel the contract on written notice to the other party. The notice will be effective 15 days after the reception."

F. Renegotiation and adjustment clauses.

We have previously considered renegotiation provisions as an alternative to cancellation because of market change. The parties might prefer to give renegotiation or adjustment greater prominence in their agreement. Renegotiation or adjustment clauses vary from the softer to the more stringent types depending on whether the parties wish to be bound to a final resolution of the impact of market change on their contractual relationship.

1. *Clauses requiring periodic renegotiation in good faith.*

While parties might consider including in the contract a schedule of regular meetings to monitor performance of the contract, usually the best solution is to give each party the right to demand a meeting if the market price increases or decreases beyond certain levels. The more specific the provision, the more likely it is that the renegotiation will produce concrete results for the affected party. The following is an example of such a clause:

> The supply price shall be subject to renegotiation in good faith, if a party communicates to the other in writing that the market

> price of the product has increased or decreased by more than 30% from the contract price and therefore the affected party seeks an adjustment of the price. The party that receives the request for renegotiation must communicate its availability to a meeting within 10 working days after receipt of the request. At least two days before the meeting, the party requesting the renegotiation shall deliver to the other party a statement of the amount of increase or decrease in market price that it seeks and the data on which it bases its claim of market change. At the meeting the other party will inform the demanding party whether it confirms or contests either the proposed market price change or the data on which it is based or both. If it confirms the proposed price change, the price will be adjusted according to the price presented by the demanding party. If it contests the price change, the other party shall present its own proposed price change (if any) and the data on which it bases its proposal, explaining why the data presented by the affected party are not accurate. The parties will negotiate in good faith for 30 days, and each party will make its best effort to find a solution to the issue. If the parties are unable to reach agreement after 30 days, the contract will be terminated at the option of the affected party.

2. *Escalator and de-escalator clauses.*

The parties might consider inserting a clause of this sort in order to increase or decrease the contract price according to changing market conditions. A clause of this type works in industries where the product or its main component has a price that is reflected in an index. Escalation or de-escalation clauses are complex. The United States Bureau of Labor Statistics has prepared a comprehensive guide for parties.[79] The guide suggests that the parties take the following steps:

(1) Establish the base selling price subject to escalation;
(2) Select an appropriate index or indexes;
(3) Clearly identify the selected index and cite an appropriate source;
(4) Specify whether seasonally adjusted indexes or unadjusted indexes are to be used;

[79] Bureau of Labor Statistic, Escalation Guide for Contracting Parties, http://www.bls.gov/ppi/ppiescalation.htm .

(5) State the frequency of price adjustment;
(6) Provide for missing or discontinued data;
(7) Specify that price adjustments shall always use the latest data as of the date of calculation;
(8) Avoid locking indexes used for escalation into any particular reference base period;
(9) Define the mechanics of price adjustment.

The escalator or de-escalator clause could operate in several ways. It could provide for automatic price increases or decreases based on the formula specified in the clause at the intervals set forth in the clause. If the parties want to take the risk of "minor" price changes, the clause could provide for price adjustment only if the market increase or decrease exceeded a certain level. Finally, if the increase or decrease is major, for example greater than 50%, the clause could provide that the adversely affected party would have the right to cancel the contract. The following is an example of such a clause:

> The price of this contract is subject to adjustment in accordance with the index formula set forth in appendix A. In the event the price adjustment exceeds 50% the adversely affected party has the right to cancel the contract on written notice to the other party.

3. *Appointment of an agent.*

Where the object of the contract (or its main component) is not a commodity or a product with a listed price, the parties might decide to jointly appoint an expert of the market (an entity or a professional) as an agent. The power of attorney should be irrevocable. The agent should have the obligation to monitor the market. The agent should also be given the authority, in case the market price rises or decreases above certain levels, to adjust the contract. The Uniform Commercial Code recognizes the possibility that parties could agree to have a price set by an expert. Section 2-305(1)(c) states that a price can be set by "a third person or agency." The following is an example of such a clause:

> The parties irrevocably appoint [insert name and details of the agent] as their joint agent. The agent will monitor the market for [name of commodity/product/service] and will submit reports to the parties every two months. The report will describe [insert content of report]. Where the agent finds that the price [of the commodity/product/service] has increased/decreased more than 30% from the contract price, the agent will communicate to the

> parties that a meeting is necessary. The parties will be available for a meeting within 10 business days from the request. At the meeting the agent will explain to the parties the result of his/its analysis. The party affected by the change will have the power to waive the adjustment. The parties will negotiate in good faith for 10 business days to find a price satisfactory for both. If the parties are unable to reach agreement, they shall inform the agent. The agent has the authority to adjust the price with binding effect on both parties. The parties may submit written information to the agent to assist him in his/its determination of the appropriate price change. If the adjusted price is more than 50% above or below the original contract price, the adversely affected party will have the right to cancel the contract on written notice to the other party.

G. Choice of law, forum and arbitration.

In choosing a governing law, drafters should evaluate the response that the chosen jurisdiction gives to a deterioration of market conditions. The same consideration should guide the parties towards the most receptive forum. Nevertheless, drafters should also consider that courts may invalidate a choice of law/forum clause when the application of the choice of law clause violates the public policy of the forum state, violates a mandatory rule of the state, is unconscionable, or was procured by fraud or duress.[80]

H. "Take or Pay" and "Hell or High Water" clauses.

So far in this section we have examined possible clauses that would provide relief to a disadvantaged party because of substantial market change. It is possible, of course, that the parties would intend just the opposite -- that neither party would have the right to obtain relief due to substantial market change or other disequilibrium of the contract. One way in which this could be accomplished is by a "Take or Pay Clause," which requires a party to pay a certain price whether it

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[80] See generally Raymond T. Nimmer & Jeff Dodd, MODERN LICENSING LAW §2:58 (Available on Westlaw). See also 2 Warren Christopher & Louis B Kimmelman, BUS. & COM. LITG. FED. CTS. §§18:39, 18:41 (Available on Westlaw).

For contracts governed by the Uniform Commercial Code, UCC § 1-105(1) (2000) states: "Except as provided hereafter in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such agreement this Act applies to transactions bearing an appropriate relation to this state."

takes the performance or not. Take-or-Pay clauses are one-sided, in that they protect the seller but not the buyer.

Another clause that could be used to require either party to perform regardless of circumstances is the "Hell or High Water Clause." The typical Hell or High Water Clause operates much like the Take-or-Pay Clause in requiring the buyer or lessee (such clauses are often used in commercial leases) to make payments regardless of the circumstances. However, it would be possible to draft an expanded Hell or High Water Clause that would apply to either party:

> The obligations of the parties are absolute and paramount duties to perform or to procure performance of this contract. The parties hereby waive all defenses arising from changed circumstances after this contract is entered into, except for material breach by the other party of its obligations under the contract. This waiver includes without limitation defenses such as impossibility, impracticability, frustration of purpose, hardship, and impediment.

IV. Conclusion.

In this paper we have examined whether dramatic market changes may be the basis of relief from contractual obligations. Under common law principles and the Uniform Commercial Code such relief is rarely, if ever, available. International commercial law as reflected in the UNIDROIT Principles and the CISG may be somewhat more receptive to these claims, but even under these bodies of law, relief would be the exception rather than the rule.

Contracting parties who wish to protect against dramatic market changes should consider including in their contracts appropriate provisions dealing with market change. This paper, with no intent of being complete, has suggested a number of types of such clauses for the parties to consider incorporating into their contracts to deal with their duties in the event of market change. There might be many other ways in which the parties can deal with market changes, to provide relief for it or to exclude any relief. The fundamental message of this paper, however, is that the parties should address market changes in the negotiation of the contract. If they choose not to do so, they cannot expect to obtain relief from courts or arbitrators.