FUNDAÇÃO GETÚLIO VARGAS
ESCOLA DE ADMINISTRAÇÃO DE EMPRESAS DO ESTADO DE SÃO PAULO

RAFAEL DE SÁ AMERICANO DA COSTA

ADAPTATION OF THE INTERNATIONAL INVESTMENT CONTRACT: THE HARDSHIP CLAUSE

SÃO PAULO
2014

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Dissertação apresentada à Escola de Administração de Empresas de São Paulo da Fundação Getúlio Vargas, como requisito para obtenção do título de Mestre Profissional em Gestão Internacional.

Campo do Conhecimento:
Gestão e Competitividade em Empresas Globais

Orientadora: Profa. Dra. Ligia Maura Fernandes Garcia da Costa

SÃO PAULO
2014

Americano da Costa, Rafael de Sá.
Adaptation of the International Investment Contract: The Hardship Clause / Rafael de Sá Americano da Costa. - 2014.
80 f.

Orientador: Ligia Maura Fernandes Garcia da Costa
Dissertação (MPGI) - Escola de Administração de Empresas de São Paulo.

1. Investimentos estrangeiros. 2. Arbitragem. 3. Contratos (Direito internacional privado). 4. Cláusulas (Direito). I. Teoria da imprevisão (Direito civil). II. Dissertação (MPGI) - Escola de Administração de Empresas de São Paulo. III. Título.

CDU 347.74/.75

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Data de Aprovação:
___/___/____.

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Dedicated to Leuser and Gilna.

Acknowledgements

This dissertation would not have been possible without the love, support, encouragement and patience I received from my father, mother and brother. I am deeply thankful and I always will be.

I have also benefited greatly from the mentoring and support of my thesis supervisor, Professor Doctor Lígia Maura Fernandes Garcia da Costa and I am indebted for her patience, critique and recommendations.

I also thank Professor Edgard Barki and the institution EAESP-FGV for the support and the opportunities that have been granted.

Abstract

This paper explores the phenomenon of adaptation of an international investment contract, in general, and the hardship clause, in specific. The aim is to provide a comprehensive analysis of the hardship clause, as a tool for adaptation and flexibility of international investment contracts in the context of contemporary legal, commercial and managerial practice. The discussion attempts to contrast the theme of adaptation of the contract due to unforeseen circumstances against the commercial imperative of investment predictability. In that sense, the study forays in the search for practical solutions in the dilemma of ensuring foreseeability of the economic relationship (contract performance) while at the same time preventing the financial ruin of one of the parties in the case of a harsh change of circumstances. The work is grounded on a theoretical investigation of the issues of adjustment of the contract; differences in national law systems and their consequences to international investment; and the hardship clause itself. As means to offer a practical understanding on the matter of adaptation of the international investment contract due to unforeseen factors, the paper analyses real cases and the prevalent trends in international arbitration.

Keywords: contract adaptation; international investment; renegotiation; hardship; excessive onerousness; arbitration

Resumo

Este trabalho acadêmico explora, em linhas gerais, a questão da adaptação do contrato de investimento internacional, e o tema ‘cláusula de *hardship’* em específico. Objetiva-se efetuar uma análise detalhada da cláusula de *hardship*, como meio de adaptação e flexibilização de contratos internacionais de investimento sob a ótica da prática jurídica e mercantil contemporânea. A discussão se centra no contraste entre a possibilidade de adaptação do contrato por circunstâncias imprevisíveis e o imperativo de previsibilidade no investimento. Nesse sentido, o estudo busca oferecer soluções práticas para o dilema existente entre a necessidade de segurança na relação econômica (cumprimento do contato) e a prevenção da possibilidade de ruína financeira para quaisquer das partes no caso de uma mudança brusca no contexto dos negócios. O trabalho está centrado em uma investigação teórica acerca dos temas de readaptação contratual; diferenças entre sistemas jurídicos de estados-nações, e suas consequências no comércio internacional; e a cláusula de *hardship* em si. Como forma de contribuir para uma compreensão prática na questão da adaptação do contrato de investimento internacional devido a fatores imprevistos, este trabalho analisa casos reais e tendências atuais observadas na arbitragem internacional.

Palavras-chave: adaptação contratual; investimento internacional; renegociação; onerosidade excessiva; hardship; arbitragem

Table of Contents

1. Introduction 11

2. The International Investment Contract 15

2.1 Definition **15**

2.2 *Pacta sunt Servanda* and revisionist approaches **24**

2.3.2 The Hardship Clause 28

2.4.1. Requirements for claiming hardship 34

2.4.2 Effects of a hardship claim 40

3. Practical Considerations for Investors and Financiers **44**

3.1 General Considerations 44

3.2 Unforeseeability 52

3.3 Excessive Onerousness 61

3.4 Externality 68

4. Conclusions **73**

5. References **76**

List of Abbreviations

AAA – American Arbitration Association

CISG – United Nations Convention on Contracts for the International Sale of Goods

ICC – International Chamber of Commerce

IMF – International Monetary Fund

FDI – Foreign Direct Investment

FPI – Foreign Portfolio Investment

M&A – Mergers and acquisitions

OECD - Organization for Economic Co-operation and Development

PPI – Producer Price Index

TGN – Transportadora de Gas del Norte

UCC – Uniform Commercial Code

UN – United Nations

UNIDROIT - International Institute for the Unification of Private Law

UPPIC – Unidroit Principles of International Commercial Contracts

1. Introduction

This academic research proposal aims to describe the so-called 'hardship clause' and to analyze the possibility of renegotiation of an international investment contract as a consequence of the application of this legal mechanism.

An international commercial contract consists in a pact between two or more parties that are subjects to distinct legal systems[1] and, at least, one of them is, or represents, a business entity. Normally, under this contract, the parties are free to choose the jurisdiction under which any possible disputes arising from the performance or interpretation of the agreement should be resolved (for instance, the judicial district of the city of São Paulo or the provincial authority of Quebec). The parties may also, should they prefer, grant such construing and ruling power to an arbitral court[2]. Furthermore, the normative sources that are to be consulted in the interpretation of the agreement may also be elected by the parties. As Venosa puts it: "Normally, the rules of the locality in which the contract was agreed upon apply. However, due to the freedom of will of the parties, both the ruling jurisdiction and the applicable law may be liberally chosen" (Venosa, 2005).

International investment contracts, are dealt in this study as a subset of international commercial contracts, and refer to those agreements pertaining foreign direct investments. Although some authors employ the terminology 'international' or 'foreign' investment contracts to designate exclusively those agreements between a foreign investor and a state (or state-entity) (Cotula, 2007), this paper seeks to

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[1] That is, as far as the contract is concerned, the legal rules of different national states may apply.

[2] Arbitral courts are non-governmental collegiate bodies, usually specialized in a field of professional, commercial or industrial activity, that, upon request and through contractual allowance, may have binding interpretive powers towards an agreement. They are normally utilized to resolve conflicts between the parties of a contract and commonly do so in accordance to pre-defined principles and rules.

discuss contract adaptation and the hardship clause within the general context of FDI operations, therefore, also including agreements between private parties.

International commercial dealings are, in their performance, susceptible to diverse circumstances that may act as impeding or otherwise gravely disturbing factors. A sudden change of circumstances may turn the dutiful performance of obligations in a long-term contract into an overwhelming burden for one of the parties[3]. The law in certain national states, like Brazil, mandates that, in the case of man-made unforeseeable circumstances, of which the affected party had no control, and in *force majeure* events, the latter may be relieved of the obligation to compensate for disobeying the contract. Barros explains that *force majeure* is an occurrence of an event unrelated to the volition or the actions of humans, such as hurricanes, earthquakes, rainstorms, whereas man-made circumstances[4] require human agency as, for instance, worker strikes, wars, arsons. In such cases, naturally, in order for an exoneration of liability to be granted, the disadvantaged party cannot have contributed for the event.

Brazilian law, like many other legal systems in the world, follows the legal doctrine known as *Rebus sic Stantibus*[5]*.* Accordingly, unpredictable events known to the parties after the conclusion of the contract that turns performance excessively onerous to one of the participants may allow for the renegotiation of said agreement[6].

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[3] Practical examples of such circumstances are: a strike in the port complex from where the agreed-upon goods are shipped; an armed conflict in the region in which one of the parties develops its activities; a natural disaster; severe social unrest, national economic meltdown, etc.

[4] In Portuguese: 'caso fortuito'.

[5] *"Matters standing thus".* (Garner, 2014)

[6] Art. 478, Código Civil: "*Nos contratos de execução continuada, ou diferida, se a prestação de uma das partes se tornar excessivamente onerosa, com extrema vantagem para a outra, em virtude de acontecimentos extraordinários e imprevisíveis, poderá o devedor pedir a resolução do contrato. [...]"*

Common law systems, on the other hand, tend to uphold a different treatment. English law, for instance, does not determine the exclusion of liability for unfulfilled contract obligations even in the case of *force majeure*. It does not obligate the parties to renegotiate the terms of the contract, either, even when an acute change in the initial economic equilibrium of the contract occurs. As Kessedjian (2005) explains,

> *In English Law, the performance of a contract is not generally excused by an adverse change of circumstances. [...] The parties must perform, however burdensome the contract may have become and however much the circumstances may have changed. There is no duty on the parties to renegotiate and no power on the courts to adapt the contract. Thus, under English law, hardship and force majeure are entirely left to contractual terms.*

One can easily foresee how relevant the choice of the applicable legal system to be followed in the international commercial contract is. It is worth noting, as well, that international normative sources may be used, such as the United Nations Convention on Contracts for the International Sale of Goods (CISG) or the International Institute for the Unification of Private Law (UNIDROIT) principles[9].

The 'hardship clause' is, in essence, a stipulation, which may be present in an international investment agreement, that allows any of the contracting parties to request the renegotiation of the clauses in the contract due to unpredicted and unprovoked events that gravely alter the initial circumstances under which the pact was agreed on, thus causing severe economic difficulties to one the parties. According to Strenger (1998),

[9] Henceforth referred as the 'Unidroit Principles', 'the Principles', or 'UPICC"

"For the hardship clause to have effect, the invoking part must have been diligent and not possess the means to reasonably avoid the occurrence or change of circumstances. The *status quo* after the fact must be fundamentally different from that which was forecasted during the conclusion of the contract and financial expenses related to the object of the pact must be far superior that those initially planned."

Renegotiation under the hardship clause is put into effect on behest of the injured party. Should the process fail, the matter is brought before a judicial or an arbitral court, depending on what is stipulated in the contract. The judge or arbitrator will act to adjust the provisions in the agreement so that an economical re-equilibrium is reached.

Hardship clauses remain a controversial topic. Any analysis about the theme must necessarily convey the tension between the subject of adaptation of the international investment contract and the requirement by investors of economic predictability. Therefore, this body of work sought to investigate the effectiveness of the hardship clause as a tool for the prevention of ruinous consequences to a party that is affected by unforeseen circumstances, while at the same providing a degree of security for the other covenant. In this effort, the hardship clause is compared to other adjustment mechanisms, such as automatic adjustment clauses. The triggering hypotheses, the procedure and the consequences of the hardship mechanisms are also analyzed.

Throughout this academic work exploratory and descriptive methodology is employed. The relevant concepts and theoretical relations between the elements in analysis are extracted from scholars and specialists whose contributions have found wide acceptance in the fields of international commercial law and arbitration. Also, in

order to provide to the reader a practical understanding of the subject under discussion real cases concerning transnational corporations have studied.

2. The International Investment Contract

2.1 Definition

An attempt at reaching a useful definition of what an investment is may strike at first glance as a simple task. Yet it is precisely its conspicuous presence in common parlance that constitutes the very hazard that eludes the nuance-rich nature of its meaning. Indeed, distinct fields of study as well as practical usage will offer their own respective interpretation of the term. The first part of this section aims to offer a brief analysis on the most pertinent definitions, particularly of foreign investment, in the context of the specific academic research on which this work is centered.

The term “investment” is described by the Compact Oxford Dictionary as: “1. the action or process of investing. 2. a thing worth buying because it may be profitable or useful in the future.” Similarly broad in its scope, the meaning of “investing” is given as follows: “the act of investing; laying out money or capital in an enterprise with the expectation of profit” (Oxford University Press, 2011). While asserting ‘investment’ as a general human activity or object, the vernacular definition does not prove very useful in the understanding of the modern economical, financial and legal aspects of the term. Central in the development of the contemporary capitalistic society, investments are usually described in theoretical economics as the production of capital goods, which are not purposely consumed, but rather utilized in future production (Krugman & Obstfeld, 2010), such as buildings, railroads and machinery. Closely related to the economic definition, in a financial sense,

investments refer to the purchase of assets (e.g. stocks and bonds, real estate, mortgages) with the intent of receiving a future income and an increased value (Stevensons, 1977).

Both approaches take for granted, as an inherent characteristic of an investment, the presence of risk. In that context, risk refers the possibility of loss of a part or the whole of the amount invested. An investor, whether a national state, a company, an investment fund or any other entity, is generally assumed to behave rationally, that is, with the intent of maximizing return and reducing risk. The activities of assessing and mitigating the risks related to a determined investment may, particularly in non-advanced economies, encompass an analysis of market regulation, the careful drafting of contracts, and the enforceability of both. Foreign investments, especially towards emerging economies, are often perceived as riskier (Khanna & Palepu, 2005).

Foreign investments can be divided into: foreign direct investments (FDI) and foreign portfolio investments (FPI). As defined by the Organization for Economic Co-operation and Development (OECD),

> Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (‘‘direct investor’’) in an entity resident in an economy other than that of the investor (‘‘direct investment enterprise’’). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and

unincorporated. (Organisation for Economic Co-operation and Development, 1996)

In line with this assumption that the FDI is characterized by a long-term, management-influencing approach, the International Monetary Fund (IMF) has published an additional understanding, according to which, this type of investment exists when the foreign investor owns at least one-tenth of ordinary shares or voting power of an enterprise or "owns less than 10 per cent [...] yet still maintains an effective voice in management". (International Monetary Fund, 2008). Foreign direct investments, whether in the form of M&As, joint ventures, greenfield investments or others, perform an essential role in the present interdependent, globalized world economy by allowing not only the transfer of financial assets among different countries, but also technology, intellectual property and other resources. In sum, FDIs indicate essentially, if not an actual willingness, at least a latent possibility of exercising a degree of control over an enterprise.

Foreign portfolio investments, on the other hand, require no active part in the management or control of an enterprise. In fact, FPIs refer to the purchase of bonds, stocks, securities or other financial assets that are usually easy to trade, often with the goal of diversifying and, thus, diminishing the risk within an investor's portfolio. As opposed to FDIs, that are usually performed by companies, foreign portfolio investments may often be undertaken by a variety of entities, such as pension and mutual funds, banks, companies, among others. FPIs may depict, at times, a high degree of volatility, for which they are prone to speculation, that is, an attempt to profit from short-term fluctuations in the value of a given asset.[10]

[Unidroit]e sort. That is: medium-term portfolio investments with a greater focus on the fundamental value of the asset than purely on rapid price movements.

Both types of investors, for a determined expected return rate, will seek whenever possible to minimize risk and transaction costs. Managing investments in foreign markets, however, require compounded efforts that take into account cultural, administrative, geographic and economic differences that might exist in relation to the investor's domestic base. Understanding and dealing with the plethora of issues and complexities that entail overseas investments require a multidisciplinary set of competences that should work together providing greater predictability and a coherent fit with the investor's strategic vision. Within that framework, particular care should be given to the drafting of contracts and to the analysis on how these agreements are interpreted and enforced by the relevant regulatory and adjudicatory bodies.

Being as such, it is necessary to comprehend and define, for the purpose of this investigative study, what an international investment contract is. Although one would be hard-pressed to find a lawyer or even a businessman who wouldn't be able to provide a definition for 'contract', in reality there is no universally accepted definition, as there are distinct legal traditions simultaneously in place and, as such, both its ontological nature and practical effects may differ. However, the massive volume of international transactions across the globe has prompted national states, international organizations and the academic community to provide common tools and definitions in an attempt to create greater harmony and predictability to international transactions and investments.

Although legal distinctions tend to be more pronounced vis-à-vis different law traditions, conceptual and practical dissimilarities may also coexist within the same legal model. To illustrate that point, it is opportune to demonstrate how the French

and the German law, both systems belonging to the Civil Law tradition[11], differ in the notion of the contract. First, France's *Code Civil*, that regulates private relations in that country, in its article 1101, defines the contract as an agreement through which one or more persons compel themselves to give something; or do; or not do something in the face of another person[12]. The German Civil Code, on the other hand, does not provide a definition for 'contract', but indicates its purpose: to create or modify the content of an obligation of one private party in the face of another[13]. French and German law diverge in that the former points to contracts as sources for the establishment of obligations between parties, whereas the latter, in addition to that, designates the contract as the appropriate mechanism for modifying existing obligations.

Given that within the same legal tradition, the notion of contract changes, it is not surprising that there is an even greater disparity when comparing to a different system of law. In the American system, mostly based on the Common Law tradition, the enactment of the Uniform Commercial Code (UCC) by all the fifty federal states since 1952 demonstrated the necessity of a harmonized system for the regulation of sales of other commercial transactions. The UCC simply states that that a contract is "the total legal obligation which results from the parties agreement" (Uniform Comercial Code, 2013). In the US system, judges and other legal practitioners also draw heavily from scholarly work to describe juridical concepts and assert legal effects. As such, one of the most widely-accepted publications in the field of private

[11] Legal systems belonging to the Civil Law tradition are principled on codes of law as a primary source of law. This is contrasted by the Common Law system, where judge-originated decisional law is given precedence. There are yet other examples of competing legal traditions such as the Hindu system and the Islamic system.

[12] Code Civil – Article 1001: *"Le contrat est une convention par laquelle une ou plusieurs personnes s'obligent, envers une ou plusieurs autres, à donner, à faire ou à ne pas faire quelque chose."*

[13] Bürgerliches Gesetzbuch - § 311-1: *Zur Begründung eines Schuldverhältnisses durch Rechtsgeschäft sowie zur Ände"rung des Inhalts eines Schuldverhältnisses ist ein Vertrag zwischen den Beteiligten erforderlich, soweit nicht das Gesetz ein anderes vorschreibt".*

law in the United States, Samuel Williston's 'The Law of Contracts', defines the contract as "a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty" (Williston, 1922). Further, Williston distinguishes the contract from: the mere agreement, which is considered to be a broader concept that includes donations, transfer of properties and simple promises; and the bargain, which would be a simple agreement to exchange promises (Goddard, 2013).

There are practical consequences to differences in the notion of contracts across distinct legal systems. In the aforementioned examples, both French and American practitioners would agree that the assignment of receivables, the relief of debt and the novation of an agreement would not be considered contracts if immediate effects were produced. However, if an obligation to assign receivables, relieve debt or novate an agreement had been established, then, a contract would be considered in place. On the other hand, whereas for a French lawyer, a bill of exchange, a check, a bill of Lading, or other unilateral declarations or promises clearly do not constitute contracts, this would not be the case for his or her American colleague. As a result, the legal ramifications would be radically different.

As would be expected, the plurality of definitions and rules concerning contracts in the international commercial and investment scene contributes, if not to raise the risk of business transactions, at least, to increase transactional costs. Such a state of affairs occurs due to the common necessity for businesses to obtain local legal support and to preemptively regard an unfamiliar regulation and adjudication system as an important factor in overseas operations. Being as such it is not surprising that common standards and concepts have been developed in an attempt to mitigate uncertainty and risk related to international commercial contracts.

The UNIDROIT Principles first publicized in 1994 constitute an important instrument in the harmonization of norms and definitions concerning commercial contracts. Indeed, the relevance and impact of the UNIDROIT Principles can be observed by the remarkable number of both domestic cases and arbitral awards in which they have been used as a legislative reference point and by the wide geographic scope of the parties involved (Agrò, 2011). The UNIDROIT Principles is a document, organized in chapters, sections and articles, that provides definitions for relevant concepts in international law and rules pertaining matters such as the formation, interpretation, performance, and obligations, in international contracts. In practice they apply when incorporated or referenced in an international contract or when an arbitrator or a judge requires a rule to fill a gap in the norm regulating that contract (Chengwei, 2003).

The UNIDROIT Principles do not expressly lay down an explanation for what an international contract would be. However, in the first paragraph of the Comment Section, it is asserted that a broad definition should apply, thus ranging

> from a reference to the place of business or habitual residence of the parties in different countries to the adoption of more general criteria such as the contract having "significant connections with more than one State", "involving a choice between the laws of different States", or "affecting the interests of international trade. (UNIDROIT Principles of International Commercial Contracts, 2004)

The use of wide and flexible criteria for the notion of international contracts is justified by the fact that the adoption of the UNIDROIT Principles as regulation for a determined contract is solely dependent on the will of the parties.[16]

[16] Which obviously does not exclude the incidence of public policy domestic law norms.

Additionally, the Principles describe what is understood by 'commercial contracts'. In this regard, a broad conceptual approach is also utilized as the Comment section of the Preamble of the Principles allude to the fact that neither party is required to possess the legal status of a commercial enterprise. Rather, the document excludes only those transactions of consumerist nature, described as dealings in which a party's engagement does not result from his trade or profession. In the same paragraph, investment contracts and concession agreements are explicitly included among those types of contracts that are meant to be considered to be of a 'commercial' nature[17].

Although the UNIDROIT Principles do not provide a definition for 'contract', the latter can be inferred by the rules set forth in the document. Indeed, within the Principles the contract is understood to be: 1. Freely agreed upon by the parties[18]; 2. Not subject to formal requirements[19]; 3. Binding[20]; 4. A creative source of obligations between the parties. These characteristics are examined with greater detail below.

According to the UNIDROIT Principles, the contract results from the autonomous will of the parties. They are free to choose whether they will enter in a contract or not and they can liberally determine its content, that is, the obligations and other aspects therein. The parties may choose, for instance, how they wish that their agreement be interpreted, by explicitly deliberating that a part of their contract is

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[17] Unidroit Principles of International Commercial Contracts (2004) – 2º § Comment section: "*[…] The Principles do not provide any express definition, but the assumption is that the concept of "commercial" contracts should be understood in the broadest possible sense, so as to include not only trade transactions for the supply or exchange of goods or services, but also other types of economic transactions, such as investment and/or concession agreements, contracts for professional services, etc.* "

[18] Unidroit Principles of International Commercial Contracts (2004) – Art. 1.1 Comment section § 1.

[19] Unidroit Principles of International Commercial Contracts (2004) – Art. 1.2

[20] Unidroit Principles of International Commercial Contracts (2004) – Art. 1.3

to be regulated by the UNIDROIT Principles, while for another section, a certain domestic law may apply.

Second, for a contract to exist, a simple consent of the parties is required. Indeed, for that agreement to be recognized in court, normally, no specific form is necessary. However, international commercial agreements are often stated in written form so as to prevent ambiguities and to assure liability of the parties for the duties for which they have bound themselves. Third, in spite of the fact that the contract is a product of free will and result in mutually stipulated obligations, it will inexorably be ruled by norms that act independently of the volition of the parties. These norms have a compulsory nature that originates from domestic law and international treaties. They also refer to the inherent duty of the parties to conduct themselves with good faith and fair dealing.

Lastly, once agreed upon, the contract becomes mandatory for the consenting parties. Both Common Law and Civil law systems derive this general rule from the Roman principle *Pacta Sunt Servanda*[21]. This feature of contracts means that non-performance by one party entitles the innocent party to either demand that the other's obligations be carried out or that compensation be dispensed - alternatively, in some cases the innocent party may also request that the contract be terminated. The principle *Pacta Sunt Servanda* dictates that all the obligations contained in a contract must be observed even if performance of any of those becomes more onerous or burdensome than what was originally expected.

The *Pacta Sunt Servanda* principle enunciates the notion of sanctity of contracts and it is regarded as a fundamental precept of the contract. However, as will be seen in the following section, certain legal doctrines have been developed

[21] "Agreements must be kept" (Garner, 2014)

and adopted across distinct national legal systems with the intent to minimize or outright prevent practical consequences of the unreserved application of *Pacta Sunt* Servanda that might be deemed unfair or socially undesirable.

2.2 *Pacta Sunt Servanda* and revisionist approaches

The *Pacta Sunt Servanda* principle consists in the legal directive that mandates that the stipulations contained in a contract must be strictly followed, so as to preserve the original intention of the parties, that are deemed to act on free-will at the moment the pact is agreed upon. This notion is rooted in Roman law, which saw a contract as an economically significant operation that bonded the parties together in nearly absolute terms, without any interference from the State. Much later, the economic and political liberalism of the 18th century, which generally embraced the ideal that individuals should be able to pursue their own interests unencumbered by state interference, revisited the old Roman understanding. The notion that the parties may regulate their dealings and create “imperative legal commandments” (Gomes, 1998) that must be mutually observed indeed remains a key aspect of modern economic life.

The *Rebus Sic Stantibus* Principle also has its origins in Roman legal philosophy. The principle was based on the assumption that if performance of an agreement between two or more individuals was possible, but due to a fundamental change in the circumstances pertaining to that pact, had become unfairly and excessively burdensome to one of them, the affected party could request that the stipulations turned too onerous be adapted. This theory generally fell out of favor among legal scholars and practitioners with the rise of liberalism due to its perceived

vagueness and the greater emphasis that was given at the time to party autonomy (Fucci, 2006).

Later, the cataclysm of the First World War, and the extreme effects it brought on European economies, prompted a 'rediscovery' of the Rebus Sic Stantibus doctrine. In France the conflict brought great imbalances to long-term contracts, such as agreements for the supply of coal and electricity, due to the enormous upsurge in demand and German appropriation of raw material in French soil. With the intent of avoiding widespread ruin, in 1918 the *Faillot* law was passed and courts were then allowed, by request of one of the parties, to terminate contracts than had been concluded prior to the start of the war, when proved that, because of the conflict, a great burden that could not have been predicted had been placed on that party (Rivas, 2013).

The *Faillot* law consolidated a wartime legal understanding that was being formed through reiterated judicial and administrative decisions. Laying the bedrock for this transitional phase of modern law, the *Conseil d'Etat*, France's highest-ranking administrative court, issued a decision that set forth what would later be known as the *théorie de l'imprévision*, or the theory of unforeseeability (Crawford, Lee, & Lauterpacht, 2009). The decision dealt with a dispute between the power company *Gaz de Bordeaux*, and the city of Bordeaux, which had granted the former a concession to supply electricity to the municipality. Gaz de Bordeaux complained that, because of the war, the price of coal, which the company used to produce electricity, had more than tripled and even surpassed the revenues received under the agreed tariffs. After analyzing the case and the special circumstances surrounding it, the tribunal concluded that *Gaz de Bordeaux* could not be expected to

perform its contractual duties within the framework of the original agreement. In its decision, the *Conseil d'Etat* stated that:

> Just as the company cannot argue that it should not be required to bear any increase in the price […] it would be totally excessive if it is admitted that such increases are to be considered a normal business risk; on the contrary it is necessary to find a solution that puts an end to temporary difficulties, taking into account both the general interest […] and the special conditions that do not allow the contract to operate normally […]; to this end it is necessary to decide, on the one hand, that the company is required to provide the concession service and, on the other hand, that during this period it must bear only that part of the adverse consequences that a reasonable interpretation of the contract allows. (Crawford, Lee, & Lauterpacht, 2009)

In that case, the court ultimately decided that the City of Bordeaux pay compensation to the power company for the incurred losses that were considered excessive, and that if the parties could not reach an agreement on this regard, a judge would establish the amount. This decision by the *Conseil d'Etat* alongside with the *Faillot* emergency law led to the incorporation of the *théorie de l'imprévision* concept in French law, which would later influence similar stipulations in other legal systems.

The theory of unforeseeability was directly inspired by the old *rebus sic stantibus* principle. It should be noted that, although both doctrines are very similar in their effects, and both deal with contractual imbalances that are created by factual circumstances, the unforeseeability theory added the requirement that these events must be unpredictable in order to allow for a contractual revision or the full dispensation from agreed duties.

Indeed, in the legal systems where the theory of unforeseeability was adopted, parties are allowed to review stipulations in the contract or ask a judge to perform this task. This faculty is given to one of the parties with the onset of a situation of excessive burden associated with the fulfillment of his or her duties due to circumstances that could not have been foreseen at the moment the contract was signed and was not caused by one the parties. Importantly, the *Imprévision* doctrine has inspired modern tools for the revision of the contract, such as the hardship clause, which will be discussed later.

There are four requirements for the rightful application of the unforeseeability theory. First, the circumstances that lead to excessive burden must have taken place after the conclusion of the contract; second, the contractual imbalance must have been unquestionably caused by the changed circumstances; third, heavy difficulty or excessive onerousness must have befallen on the party that dioeviates from the regular fulfillment of the original contractual obligations; and lastly, the alleged circumstances or the effects thereof must have been unpredictable by the affected party.

This last requirement comprises certain peculiarities. First, not only the unforeseeable change in circumstances allows for the application of the theory but also, if the events are foreseeable, but its consequences are not, the doctrine may also be invoked. Second, the referred events must necessarily have a direct impact on the contractual performance of the affected party and that should be unequivocally demonstrated. This impact is generally expressed in the dramatic increase in the costs perceived by one party to perform its duties or, alternatively, in the abrupt reduction in the value of the received allotment. The question of the

unpredictability of events in international business is of immense relevance in the topic of contractual revision and is discussed specifically in another section.

The *Rebus Sic Stantibus* principle, the unforeseeability theory, and other similar doctrines, have given rise to legal mechanisms called 'revision clauses' that effectuate the re-examination and adaptation of contracts in the event of an unexpected change of circumstances that create an excessive burden over an individual engaged in a contract. Although there are different types of revision clauses, each with its own set of peculiarities, their ultimate goal is to promote the re-equilibrium of contractual duties and the preservation of legal and commercial ties between business partners. Such instruments are essential for the development of international trade in view of the uncertainties and constant change across the globe.

2.3.2 The Hardship Clause

A long-term international investment is naturally prone to be affected by a myriad of circumstances. Contracts that regulate such endeavors often (and wisely) address issues and events that may adversely act against the original expectations of the parties involved. Whereas certain supervening factors may impede the very continuity of a given commercial relationship, there are other instances in which an adjustment of the affected agreement is preferred.

Fluctuations and risk are well-accepted traits of international trade. As such, economic actors privy to this field of activity may agree to contractual adjustment mechanisms in order to forestall negative and potentially devastating consequences from the modification of circumstances. Adjustment clauses may be utilized to offset normal market factors, such as inflation; currency variation and regulatory issues or they may refer to unexpected changes in circumstances, such as drastic shifts in

operational costs due to wars or natural disasters or sudden changes in government policy. In the latter case, parties usually obligate themselves, should the circumstances require, to negotiate terms within the contract in order to reestablish the originally intended economic equilibrium, thus preserving that economic relationship (Berger, 2009).

As they usually do not spell out concrete outcomes or, sometimes, triggering events, renegotiation clauses are naturally open. In so being, they distinguish themselves from stabilization clauses, which automatically adjust terms in the contract with the occurrence of clearly defined events. Renegotiations clauses, instead, are aimed at those events whose occurrence, or consequences to the performance of the contract, cannot be easily predicted, and thus require an approach that is more flexible and *ad hoc* in nature.

Renegotiation clauses may be explicit or implied. In the first case, the parties to an agreement expressly agree to the possibility of renegotiation, and establish the relevant conditions and procedure, while in the latter the law regulating the contract obligates the parties. In any event, renegotiation clauses must contain the following: a definition of the sort of events (or consequences) that could trigger the renegotiation process; the actual obligations of the parties (merely to attempt a negotiation or to reach an agreement?); and the effects of a failure in the renegotiation process (termination of the contract or decision by a third-party?) (Berger, 2009).

Hardship provisions are a type of renegotiation clause and establish the consequences of a drastic change in the economic equilibrium of a contract, which, although severely unbalanced has not had its performance made impossible (Kessedjian, 2005). These clauses may be prescribed by domestic law, or be

described in international non-binding normative[23] or, as previously stated, may be explicitly agreed upon in contract by brokering parties. They find themselves in close association with doctrines, such as *rebus sic stantibus* and the *théorie de l'imprévision* and constitute presently one of the most ubiquitous and significant revision mechanisms for commercial contracts.

Hardship provisions or 'clauses' distinguish themselves from other contractual revision and adaptation mechanisms by directing parties to a renegotiation or review process due to the occurrence of an unforeseeable and external circumstance that results in excessive economic burden to one of them (Rimke, 2000). The hardship clause has found its way in the legal system of several countries under the guise of terms such as *frustration of purpose, Wegfall der Geschäftsgrundlage, imprévision, eccessiva onerosità sopravvenuta,* etc*.,* although interpretation regarding its implementation may vary somewhat. The expression 'hardship' seems to have been widely favored by international practitioners most likely due to its usage in established international statutes such as the Unidroit Principles and the Principles of European Contract Law (Chengwei, 2003) and also in order to avoid ambiguities with minutiae associated with specific national terminologies.

There are indeed several examples of domestic law systems that allow or actually obligate parties to enter renegotiation of the contract in the case of hardship. The Brazilian Civil Code, for instance, provides that, should extraordinary and unpredictable events fall upon a party, making regular contractual duty 'excessively onerous' (*excessivamente onerosa*), the other party may offer, before a judge, more 'equitable' terms as a means to avoid termination of the contract (Brazilian Civil

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[23] There are several texts of law proposed by international organizations to serve as a guiding law for international commercial relations. They are non-binding in nature because they will only regulate an international commercial transaction if indicated in contract by the parties. Examples of suck text of law are: the UN Convention of Contracts for the International Sales of Goods (CISG); the Unidroit Principles of International Commercial Contracts; and the Principles of European Contract Law.

Code, art. 478; art. 479). Similarly, Dutch law grants courts, upon request by one of the parties, the power to either modify or terminate a contract on the basis of unforeseen circumstances "of such nature" that the other party may not "reasonably and fairly" expect the contract to be maintained in its present form (Burgerlijk Wetboek book 6 art. 258). German, Portuguese and Greek laws have provisions that are equivalent to the Dutch Civil Code, also allowing judges to terminate or modify contracts in the case of 'hardship' (Uribe, 2011). Curiously, in France, where the *théorie de l'imprévision* originated, both the codified law and court jurisprudence point to the opposite direction and allow for neither the possibility of adaptation of the contract nor the termination of private law agreement by judges in the case of hardship (Zivkovic, 2012). In that country, only public law contracts, that is, those agreements in which one of the parties is a state entity, can be modified under the *imprévision* doctrine (Zivkovic, 2012).

On account of a variety of multilateral treaties signed by countries participating in international commerce and investment, parties to transnational agreements are generally free to choose the applicable law of the contract. As a matter of fact, international contracts may even contain an amalgamation of rules derived from distinct systems of law or even no reference to national law at all, especially, when arbitration is chosen as the appropriate forum for dispute resolution (Maniruzzaman, A. F. M., 1999). Although it is also possible for a domestic court to interpret a contract in accordance with foreign law, international soft law or even customary principles of trade, this remains a very controversial and complex issue in many countries. In this context of increasing prestige and demand for international arbitration, parties can nearly create an "independent legal order", resorting, if they choose, to an extraneous code of law for the mere expedient of filling up eventual

gaps (Verdross, 1964). As such, given the complexity and specificities of different sectors of international trade, it is not at all uncommon that parties to a long-term international trade or investment agreement formulate themselves a clause on hardship.

In the cases where parties choose to establish a hardship clause outside the realm of national law, they may, out of convenience, and in order to avoid the strenuous task of drafting norms over every aspect of such a highly complex mechanism, choose instead to indicate a supranational “soft law” as a regulatory reference. Soft law, simply put, is a non-binding legal instrument, such as the UN General Assembly Resolutions, statements, principles, codes of conduct etc., that, in the context of international law, may be referenced to as a regulatory tool or instrument of interpretation (Boyle, 1999).

As mentioned earlier, the soft law known as the UNIDROIT Principles has had wide acceptance in international arbitration and even among domestic courts worldwide as an important regulatory source for the interpretation of international contracts (Bonell, 2007). Indeed, as a testament to the acclaim awarded to the Principles, arbitral courts worldwide have been applying the text as an interpretative tool when parties merely indicate that their contracts follow *lex mercatoria* or ‘general principles of law’ rules (Bonell, 2007). Regarding specifically to the regulation and interpretation of hardship in international commerce and investment, the UNIDROIT Principles have shown to be particularly useful.

Indeed, the working groups that drafted the text sought to restate common and well-accepted norms in international commercial practice, in a comprehensive, descriptive and clear fashion. Pertaining the issue of hardship, an entire section was dedicated to describe the phenomenon, alongside commentaries and concrete

examples, and to indicate the legal consequences of the event. Such is the influence of the UNIDROIT Principles that scholars often refer to the document as the most important source of codified law in the discussion and interpretation of hardship in international contracts (Berger, 2009); Aquino, 2004); Kessedjian, 2005); Fucci, 2006); Goddard, 2013); Simon, 2012).

Although hardship is considered an exceptional event, it does not constitute, under the UNIDROIT Principles, a permissible cause for the dereliction of one's contractual duties in an international contract. Instead, the Principles assert that under such circumstances, the disadvantaged party should engage the other(s) in a renegotiation process of contractual clauses, with the aim of bringing about an equitable solution. In case the parties fail to reach an agreement within a reasonable time, the Principles determine that either party may resort to a third-party, which may promote the adaptation of the contract or terminate it.

Although it takes into account the possibility for adaptation of contracts, the section dedicated to 'hardship' in the UNIDROIT Principles stresses that, as a rule, contracts must be kept even when the fulfillment of one's obligations becomes more onerous, or one's gains come to be more modest, than previously expected. Indeed, the provision of article 6.2.1 is very clear in that sense. It states: "*Where the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations subject to the following provisions on hardship."* (UNIDROIT Principles of International Commercial Contracts, 2004)

Accordingly, even if one of the parties experiences financial losses instead of the previously projected profits, the contract must be kept. As such, the *Pacta Sunt Servanda* principle remains a guiding principle of a contract that is governed by the

UNIDROIT Principles, whereas any adaptation is deemed as an extraordinary event in the “life” of the agreement (Maskow, 1992).

At any rate, one must consider that none of the provisions contained in the UNIDROIT Principles are mandatory, unless agreed to by the convening parties. As they are free to regulate their agreement, parties may, in regard to renegotiation and adaptation, for instance, exclude a set of circumstances from the reach of a hardship clause, such as any sort of currency fluctuation (Chengwei, 2003). In any case, should parties agree to orientate their contract in accordance with the UNIDROIT Principles, hypotheses that give rise to a renegotiation of the agreement will only operate in exceptional circumstances. Neither the text in the UNIDROIT Principles nor arbitral practice construe the concept as a means for a party, that has later merely become frustrated with the contract, to request a change in its content.

2.4.1. Requirements for claiming hardship

The UNIDROIT Principles pursue, not only an attempt to unify common rules existing in domestic law systems, but also, to offer a clearer and innovative approach to problems in the course of international trade. When faced with complex issues and apparently irreconcilable differences, the text is not omissive nor does it recur to ambiguous wording, but rather provide clear-cut and objective solutions to the international market (Zaccaria, 2004). That is the case with the issue of hardship and, as such, the following two sections will be based on the standards set forth by the UNIDROIT Principles.

The Principles provide a general rule for under what occasions hardship can be invoked. The text asserts that there is hardship ‘where the occurrence of events fundamentally alter 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 diminishes'. Further, however, four additional requirements are put forth: 1. The relevant events "occur or become known after to disadvantaged party after the conclusion of the contract"; 2. These events "could not have been reasonably take into account by the disadvantaged party at the time of the conclusion of the contract"; 3. They were "beyond the control of the disadvantaged party"; 4. The risk of their occurrence "was assumed by the affected party." (Unidroit Principles, Article 6.2.2 a, b, c, d,

Hardship clauses may be formulated in a subjective or objective approach. Clauses with a subjective character may emphasize the internal assessment of parties of what constitutes the conditions that form the basis of that economic relationship (Maskow, 1992) or they may refer to criteria such as 'fairness' and 'equity' (Zaccaria, 2004). On the other hand, an objective approach such as the one upheld in the Principles, aims to extricate the existence of a hardship situation according to measurable figures or relevant external factors surrounding the case at hand (Girsberger & Zapolskis, 2012).

The UNIDROIT Principles are guided by the assumption that even if a change in circumstances relevant to a contract negatively affects a convening party, the obligation to perform their due remains unfazed. This way, it follows that a hardship claim may only be acceptable when there is a fundamental alteration of the equilibrium of the contract and, therefore, a foreseeable change in the economic context of a commercial relationship does not entitle the unhappy party to request a renegotiation. Rather, under the hardship excuse, adaptation of the contract will only occur when the performance of one's obligations, though still possible, has been severely affected, creating exorbitant costs or losses.

The written formula utilized in the UNIDROIT Principles and its subsequent interpretation by arbitral courts and commentators clearly demonstrate that an ordinary disequilibrium is not enough to characterize hardship (Chengwei, 2003). Parties are disallowed to claim hardship as a pretext to transfer economic risks to others as this would go against the foundations of a market economy. However, precise measurement of what constitutes a fundamental change in circumstances is a difficult task and depends on the specific factors surrounding each case.

There cannot be a general rule that expresses a numerical threshold for what should constitute extreme losses or costs. Nevertheless, an official commentary in an earlier version of the UNIDROIT Principles stated that a 50% increase of cost or decrease of value could be considered enough for the characterization of a fundamental alteration of the equilibrium (UNIDROIT, 1994). However, the commentary was removed in 2004 as it was considered too low and arbitrary by specialists (Girsberger & Zapolskis, 2012). The fact remains that other factors must be analyzed such as how much risk did the affected party assume or their financial status and capabilities.

The UNIDROIT Principles provide a general description for hardship and not an enumeration of events (Maskow, 1992). Nevertheless, the text offers case illustrations and examples of events that may drastically affect the performance of an international contract. In one example, a merchant from the former German Democratic Republic orders electronic goods from a manufacturer located in another socialist country to be delivered in December 1990. However, with the unification of the two German states in November of that year, the buyer informs the seller that there isn’t a market for those goods anymore and calls off a large share of the order.

The case is understood as an acceptable claim for hardship. (Unidroit Principles Article 6.2.2 – Comment Section)

The Principles also give examples of factors that may lead to severe increase of costs or decrease of value. An increase in the purchasing price of raw materials needed for the production of goods or provision of services or the introduction of new safety regulations in manufacturing are examples of the former. As for the decrease in the value of the performance, the Principles point to the effect that an abrupt increase in inflation may have over a contractually agreed price or the effect of an export embargo on goods acquired with the goal of a subsequent export operation.

The hardship clause can only be evoked as a means to correct an imbalance on obligations yet to be performed. As a consequence, the affected party is not authorized to unilaterally breach the contract and cannot request a redistribution of costs (or losses) from obligations performed in the past. Being as such, any party is liable for damages caused by an unannounced interruption in the performance of the contract.

Besides the occurrence of a fundamental change in the contractual balance, the UNIDROIT Principles describe four additional requirements for the characterization of hardship. These are: 1. The events must have occurred or become known to the affected party after the conclusion of the contract; 2. The events could not have reasonably been taken into account; 3. The events must have been ‘beyond the control of the disadvantaged party; 4. The disadvantaged party did not assume the risk of the event’s occurrence. (Unidroit Principles Article 6.2.2)

The first additional requirement, pertaining the time at which the events became known to the disadvantaged party, quite simply negates the possibility of a hardship event in the cases where the claimant was aware of the relevant events

before concluding the contract. As such, for the characterization of hardship, it is not relevant whether the march of events started before or after the conclusion of the contract as long as it remained unbeknownst to the affected party. However, per the second additional requirement, plead of ignorance by itself is not enough.

Indeed, the second additional requirement appeals to the reasonableness that the affected party could not have predicted the occurrence of the events. Such a condition refers to the assumption that global players in international investment and trade are professional entities and are deemed responsible for properly analyzing the factors and variables that expectedly influence their dealings. Therefore, as understood by arbitration courts, a hardship clause cannot be relied upon as a relief for one's own negligence (Berger, 2009).

The question of whether a set of events can be foreseeable is a key concern to the hardship case. The general notion in international business is that if the parties can foresee a potentially negative event, it should be dealt with in their contract. Failure to address a foreseeable hazard obligates the remiss party to perform its duty, in case the event comes to reality, no matter how onerous the obligation has become.

At times, an intricate analysis is necessary to determine whether the deleterious facts (or their consequences to the contract), could be foreseen or not. However, international arbitral tribunals over that past decades have emphasized the high level of responsibility expected from businessmen in the international scene and as such presume that reasonable parties would provide against adverse changes in socioeconomic circumstances (Berger, 2009). The hardship excuse, therefore, would operate only where diligent parties could not reasonably foresee events.

Another condition for hardship is that the disadvantaged party did not assume the risk that the relevant event could happen. Assumption of risk can result not only from explicit clauses, but also from the nature of the contract (such as prospective undertakings) or can be implied (Maskow, 1992). An example of the latter is the case in which a price-adaptation mechanism, such as an indexation clause, is explicitly stated in the contract. Should there be a price increase that is not covered by the clause, the disadvantaged party is expected to bear the additional burden, since the possibility of a fluctuation in price had actually been foreseen.

As stated previously, assumption of risk can also derive from the nature of the contract. It is expected that parties that enter into speculative transactions accept a higher amount of risk even if they were not fully aware of it at the time the contract was signed (Chengwei, 2003). This way, an insurance company is not allowed to deny payment to an insuree merely because events were far more severe than was anticipated. Likewise, a financier may not claim hardship on grounds that a transaction in the futures market did not follow through in its calculated outcome. Therefore, even if unforeseen events overburden a party in a severe way, it will be nonetheless obliged to fulfill its duty if the contract was of a speculative nature.

The last requirement is that the occurrence of events deemed to have caused hardship must have been beyond the control of the disadvantaged party. This disposition aims to exclude from the reach of hardship those events that actually occur because of the party's actions or omissions, namely those related to the party's regular business processes or those that could otherwise be reasonably prevented. In that line, Kessedjian (2005) states that

> internal excuses connected with business operations, general management of the company, financial structuring of the activities or social management of

the undertaking, will probably never be accepted as events beyond the control of that party.

Likewise, state entities often find it rather difficult to sustain a hardship case related to circumstances brought about due to public policy. Indeed, in those cases, international arbitration courts tend to disregard the separation of legal denominations between a public company and its parent government entity (Fucci, 2006).

Finally, it should be restated that, in accordance with the UNIDROIT Principles, parties in international commercial agreements have broad autonomy to decide on the rules of their contract. Being as such, in the case of hardship, parties are free to extend or restrict the requirements for its acceptance as they see fit. In reality, provisions in long-term international contracts should and often do determine rules and consequences for the cases where supervening events may occur, such as renegotiation clauses under certain standards, or price-adjustment mechanisms. Nevertheless, there may be circumstances that escape parties in the drafting stage of their contract. Also for this purpose, as a gap-filling tool and an interpretation law, the Principles, with their general character, fulfill a very relevant role.

2.4.2 Effects of a hardship claim

Where a party feels burdened by what it considers to be a case of hardship, a request for renegotiation must be given to the other party. This request must be made without 'undue delay' and indicate the 'grounds on which it was based' (UNIDROIT, 2010)[35]. It should be noted, however, that this action by the affected

[35] Article 6.2.3 – 1

party does not entitle it to withhold performance. In that case, the nonperforming party would be liable for the losses and damages suffered by the other.

The Principles indicate that the affected party must request renegotiation without undue delay in relation to the occurrence of the hardship event. Although no consequence is established for the delayed presentation of the request (though the parties may write one into the contract), an official comment in the UNIDROIT Principles allude that it may become difficult to prove the occurrence of the event, or its impact, if a delay occurs. Also, it may happen that the relevant events were taking place for a long period in the past but that only the acceleration of their pace or the increase in their intensity may have caused the hardship event. In any case, as a rule, parties cannot interrupt the fulfillment of their duties prior to renegotiation of their contract and, therefore, a delay in claiming hardship would only act against the disadvantaged party's interests.

Likewise, the affected party must explain to the other the grounds on which the request is justified. This is necessary, as it will give the other party the opportunity to assess whether a hardship event is indeed present or not. If the grounds for the request for renegotiation are not fully present, the latter will not be considered untimely and the renegotiation process may not be initiated. An exception to this rule is the situation in which the relevant events have been so obvious and pervasive that a detailed justification is not needed.

The renegotiation process between parties must be conducted in good faith (UNIDROIT, 2010, Article 6.2.2; Comment 5). In this sense, a hardship claim may not be effectuated as a purely tactical maneuver, as a means for coaxing the other party into conceding to unreasonable gains. Also, during the process the parties have a duty to cooperate and refrain from any sort of obstruction, by providing all the

necessary information for the fulfillment of an equitable solution. Bad faith is present, for instance, in the cases where a renegotiation process is abusively extended or broken off or when the claimant has entered into another, incompatible contract with a third-party all the while the renegotiation is still occurring.

Where the renegotiation process has failed or has been evaded by one the parties, either one of the covenants may bring the hardship case to court [38]. Evidently, the reference in the Principles to a ‘court’ does not indicate necessarily a domestic court of law, but may also signify an arbitration court or another third-party nominated in the contract, such as a collegiate of experts. In this case, if the parties provided for it, the court will have to adhere to any interpretation and limiting rules established in contract.

Once the hardship claim is submitted, the court may follow either one of the three following paths:

1. Uphold the original stipulations in the contract;

2. Adapt the necessary terms of the contract in order to restore its original equilibrium; or

3. Terminate the contract, with fixed terms and conditions.

The first pathway is reserved not only for an unfavorable decision in regard to the hardship claim. In fact, it may be followed due to the specific circumstances of the case, and in this event the court may request that the parties return to the negotiation table or may simply consider unreasonable that the contract should be adapted or terminated, even with the occurrence of hardship. An example of such of a case is that of a three-year importation contract of beer, where, in the second year, the country to which the product is sold suddenly prohibits the consumption and sale

[38] Article 6.2.3- 3

of alcoholic beverages. In this case, the court may decide that, even though a hardship event is present, there remains the possibility to sell the beverages in a neighboring country, and therefore, the contract should stand, even if more onerous to the disadvantaged party. Where that possibility does not exist, then the court may choose instead to terminate the contract (UNIDROIT, 2010) or adjust it, depending on the circumstances.

As stated before, adaptation of an international contract by a court remains a heavily disputed issue and is still considered a measure of exceptional nature. This of course results from the presumption of competence and expertise of the parties and the assessment that the undertaking of negotiation between the parties is the most adequate remedy to a hardship crisis. Nonetheless, by agreeing to the resolution of a hardship case in court, it is possible that the parties delegate this responsibility to a third-party, usually, an international arbitration tribunal. When confronted with such an affair, given the possibility, it is the duty of the court to adapt the contract with a view to restore it to its previous equilibrium.

In the process of such a laborious task, the members of the arbitral court will seek to adhere to the procedural and substantive rules determined by the contract for this eventuality (if they exist) and to the internal regiment of that adjudicatory body. In the course of the proceedings, parties are given the chance to address the court and external specialists may be summoned to provide information and analysis that will serve a source for the later decision. Regarding the general objectives sought by the court, the aim is to achieve an equitable distribution of the losses between the parties.

Although the adaptation of an international contract often deals with adjustments in price, a court may decide that a change in a different type of clause is

a more appropriate remedy. For example: the place of delivery of goods may be modified; or the time for the fulfillment of obligation may be extended. It must be noted, however, that the court is in now way allowed to rewrite the contract to such an extent that a completely new agreement is imposed on the parties. The adaptation must be restricted to the minimum, only as means to redistributing the losses from hardship equally between the parties.

The decision by the court must also take into account, if applicable, the extent to which the affected party assumed the risk of the negative events. This goes in accordance with the determination that only the risk of unforeseen circumstances must be borne equally by the parties. Also, and importantly, the modified clauses of the contract will only be in effect for the duration of the hardship crisis. Therefore, as soon as the circumstances that gave cause to the hardship claim cease to exist, the performance of the contract should return to normality.

3. Practical Considerations for Investors and Financiers

3.1 General Considerations

As stated elsewhere, a great number of domestic law systems recognize the incidence of the hardship concept in contracts. That is particularly true, for historical reasons, in countries that follow the Civil Law tradition, where the *théorie de l'imprévision* and the Roman Law principle *Rebus Sic Stantibus* have found fertile ground to blossom. As many of these countries are important recipients of foreign investment, it is important for financiers, investors, and their respective agents, to incorporate in their strategic planning an understanding of the most relevant points regarding the hardship clause.

Long-term investment contracts, such as concession agreements and infrastructure development, often contain adjustment mechanisms that deal with domestic inflation, changes in prices in supplies, currency fluctuations etc. It is also prevalent among these types of contracts the presence of force majeure clauses, that establish the circumstances under which one party may be excused from due performance of its duties in the contract. However, arbitral literature has shown that clear provisions that deal with hardship clauses are often perilously absent (Fucci, 2006) from these agreements, thus allowing great latitude for judicial interpretation in those countries where the principle *Rebus Sic Stantibus* is recognized.

Indeed, when a contract is silent regarding the possibility of renegotiation due to the hardship clause, it will be the law governing the agreement that will indicate whether such an allowance (or obligation) exists or not. Most legal systems based on Civil Law, for instance, do not force a renegotiation process unto the parties due to circumstances of excessive onerousness, under the terms of hardship. Nevertheless, there are notable exceptions, such as, for instance, the State of Algeria, whose law empowers judges to renegotiate the terms of an agreement, independently of the will of the parties. The Civil Code of that country purposely states:

> When as a result of exceptional and unforeseeable events of general character, the performance of the contractual obligation, without becoming impossible, becomes exceptionally onerous in such a way as to threaten the debtor with exorbitant loss, the judge may, according to the circumstances, and after taking into consideration the interests of both parties, reduce to reasonable limits, the obligation that has become excessive. Any agreement to the contrary is void.

Should a contracting party feel unfairly burdened, this party may only request *in judice* or to the competent adjudicatory body the termination of the contract, which would of course lead to different legal consequences. On the other hand, should the contract stipulate criteria for the determination of a hardship situation and for the ensuing renegotiation process, a third-party with decisional power, be it a judge or an arbitrator, would generally have to adhere to such preconditions, while delineating new terms for the contract.

Being as such, should the investor opt for inserting a hardship clause in the contract, it would be advisable, given the purpose of diminishing risk and uncertainty, to define certain rules or minimal standards that would protect the investment should a hardship event occur. These could take the form of a stipulation that guarantees, even amidst a hardship situation, a minimal level of profitability or a payment high enough to cover the cost of capital borrowed by the investor (Fucci, 2006). It may also, for instance, establish prohibitory determinations that forbid the modification of certain provisions in the contract in the event of hardship.

Establishing criteria for a trigger point to a hardship occurrence as well as for the proceeding renegotiation undoubtedly confers a higher degree of security and greater accountability between the parties. However, regardless of the establishment of a provision concerning hardship, parties are well-advised, in a long-term agreement, to provide mechanisms for adjustment to external events such as: inflation, changes in law, currency fluctuation, among others. This serves two important goals: first, it gives parties financial predictability, allowing for planning in accordance with the indicated scenarios; second, it demonstrates that the parties foresaw certain changes in the contract equilibrium, thereby assuming the risk and

eliminating a key component for the allegation of hardship and the ensuing unintended modification of the contract.

One case that illustrates how the careful drafting of adjustment mechanisms into the investment contract can prevent successful hardship claims is that of the dispute between the US-based CMS Gas Transmission and the Argentine Republic. In the early 1990s, as the Argentinian government was selling many of its utility companies, CMS acquired a 30% stake, worth US$ 175 million at the time, in the newly-formed Transportadora de Gas del Norte (TGN), a gas distribution company. TGN would be remunerated by tariffs that were to be calculated in US dollars and converted to Argentinean Pesos at the time of billing. The tariffs were also to be adjusted every six months according to the US Producer Price Index (PPI) and every five years a new adjustment would be made in order to preserve the real value of the dollar.

Beginning in 1998 Argentina found itself engulfed in a series of events that led to a major economic depression and political collapse. As part of its measures to deal with the crisis, the government imposed a general moratorium on the PPI and inflation-indexed adjustment of tariffs across utility contracts, including that of TGN, under an agreement that the utility company's shareholders would later be compensated for the lost revenue (ICSID Case No. ARB/01/8, 2005). However, shortly thereafter, a domestic court annulled the agreement and subsequently in 2002 an emergency law was passed removing the rights of all concession-holders to calculate tariffs according to the US PPI and redenominating all dollar-based tariffs into Pesos in a one-to-one basis. At the same time the Currency Board system, that maintained a fixed currency rate, was eliminated and the Peso was effectively devalued trifold against the US Dollar.

The circumstances led CMS to file a claim in the International Center for Settlement of Investment Disputes, under a bilateral treaty between the United States and Argentina - The Argentina-US Bilateral Treaty Concerning the Reciprocal Encouragement and Protection of Investment, in force since 20 October 1994 - which establishes arbitral court as the competent jurisdiction for such cases. CMS argued that the government's actions had lowered the value of its TGN equity from US$ 261 million to only US$ 17.5 million. Furthermore, because of the termination of the US PPI-adjustment system and the redenomination of the tariffs to Pesos, revenues were said to have dropped 75%, effectively preventing CSM from even paying off the debt it had incurred in its investments on TGN's infrastructure. In their rebuke, the Argentine representatives:

1. Disputed the figures claimed by CMS;

2. Argued that the Claimant's financial issues resulted from excessive leveraging;

3. Cited diminished operational costs for CMS because of the redenomination; and

4. Attempted to renegotiate a retroactive tariff increase, albeit without success.

Argentinian law regulated the international investment contract between CMS and Argentina. The latter relied upon the *théorie de l'imprévision*, to sustain the right to renegotiate the agreement. That legal doctrine which permeates the Argentinian law and jurisprudence, finds itself in the Argentinian Civil Code, that similarly to the UNIDROIT Principles, determines the possibility of an 'equitative' renegotiation of a contract that has become excessively onerous for one party due to unpredictable and extraordinary events (Art. 1198 of the Argentinian Civil Code). As a result, the

government maintained that a contractual breach had not taken place, given the deep crisis in the country.

In spite of Argentina's allegations, the court ordered the state to pay US$ 133.2 million in compensation to CSM. The allegation of hardship was not accepted since the original contract between the parties clearly determined that the State would not "freeze the tariff regime or subject it to price controls" or "alter the basic rules governing the License without TGN's written consent" (ICSID Case No. ARB/01/8). Written as such, the Argentinian government had essentially assumed the risk of the conjuncture, which it found itself in. Additionally the court considered that government policies before and during the crisis had a direct effect on the change of circumstances and on the initial equilibrium of the contract. Being as such, the tribunal determined that, in accordance with Argentina's law, essential elements that make up the hardship event were missing and, therefore, among other reasons, it was decided that the modification of the rules in the contract had been unlawful and that the government was guilty.

Another interesting case of attempted renegotiation due to hardship in an infrastructure agreement is that of Brazilian energy-giant Petrobras with El Paso energy and with a consortium called MPX Energia, which an American company called MDU Resources was part of. Those agreements took place following the drought-induced 2001-2002 Brazilian energy crisis. Brazil is heavily reliant on hydric sources for its energy production. Around ¾ of the country's energy is produced hydroelectric plants (Delloite, 2010). This assumption led the state-controlled Petrobras to license the construction and operation of a certain number of thermoelectric power plants across Brazil in order to increase the supply of energy, which at the time was insufficient – as it is currently - to satisfy the country's needs.

Petrobras managed to attract partners for this project by agreeing that, if a normalization of the energy situation diminished the revenues from those plants down to a certain level, periodic contingency payments at a pre-defined value would be made so that those companies would have a ground-level of profitability guaranteed for at least five years (Schueffner, 2005).

With the end of the energy crisis, the spot price for electricity decreased from R$ 680/MWh at its peak to R$ 18/MWH in January 2005 (Fucci, 2006), and as most of the new thermoelectric plants had already been built and had started operating, Petrobras was obliged to perform the contingency payments, as determined in the contract with the foreign energy investors. Pressed by the prospect of an expenditure of over R$ 4.5 billion (Monitor Mercantil, 2005) as a consequence of the agreement, Petrobras sought a renegotiation agreement in the terms of the contract.

In the beginning of 2005, the company did not make the contingency payments to MPX and El Paso as required per contract. Instead, Petrobras submitted the separate amount of both payments in escrow through separate proceedings in a Brazilian court (that would eventually dismiss Petrobras' claim). Further, Petrobras took its claim to the American Arbitration Association (AAA), that in both the cases of MPX and El Paso was the adjudicatory court indicated in the contract for settling any disputes pertaining to those agreements.

Petrobras stated that under Brazilian law, which regulated both contracts, a contractual revision was deemed possible "if unforeseen changes to the initial scenario occur". The company also claimed that its shareholders had been "excessively burdened by the profits of its partner because the situation has changed drastically" (Petrobrás, 2005). Brazilian law does indeed make an "equitative modification" of the contract possible during court proceedings when its performance

is considered “excessively onerous for one the parties” due to “unforeseeable and unpredictable events” (Art. 478 of the Brazilian Civil Code). As such, if conditions are met, a party can indeed request renegotiation of a contract.

However, in the case of Petrobras, the Brazilian court that first examined the issue issued an unfavorable decision partly due to contract stipulations that determined that the company would honor the contingency payments under any circumstances. In addition, the court dismissed the claim that the events that prompted the obligation for contingent payments were “unforeseeable”, since Petrobras could not have expected that the climatic conditions that prompted the energy crisis would remain the same (Fucci, 2006). Despite the fact that the case has been taken to an arbitration court (AAA), Petrobras negotiated a settlement with both El Paso and MOX Energia and so no arbitration award was issued.

In both of the aforementioned examples (Argentina vs. CMS and Petrobras vs. MPX and El Paso), the international investment contract was regulated by a domestic law system that provided for renegotiation of the agreement in the case of a hardship event. Investors and lenders should be aware that, under such legal systems, especially in countries with a recurrent or long-standing pattern of some political and economical instability, courts may find it well-justified to adapt a given contract to those changed circumstances. This stems from the assumption in such countries that, in view of perpetually unstable and erratic economic environment, courts should play an active role in adjusting economic relations.

The two cases that were discussed illustrate precautions that should be observed in the negotiating and drafting stage of the international investment agreement. Most importantly, they show the importance of clear provisions indicating the extent of risk in the contract to which the parties have obliged themselves. In the

Argentina vs. CMS case, the state entity's explicit commitment not to subject tariffs to price controls was cited by the arbitral court as evidence that performance of the contract was guaranteed against adverse macroeconomic factors. In the Petrobras' affair, the guarantee to honor the contingency payments 'under any circumstances' clearly indicated the extent of risk assumed by the Brazilian company. Undoubtedly, such a guarantee was instrumental in attracting foreign partners for the emergency thermoelectric projects.

3.2 Unforeseeability

As previously discussed, domestic law systems and international soft law texts that provide for the renegotiation of a contract due to hardship indicate, as an essential requirement, that the events said to have led to that extreme change in the initial equilibrium in the agreement be considered unforeseeable. However, it is certainly not an easy task to ascertain what kind of events or change of circumstances may be considered unforeseeable. It is important that stakeholders in the international investment ambiance understand how arbitral courts have been interpreting this aspect of the hardship theory in actual international investment disputes.

First of all, consideration must be given to the distinction in the interpretation of contracts given by Civil Law and Common Law countries. Traditionally, in the latter, the contract draft is the proper instrument to allocate the risks assumed by each party (Fucci, 2006). Notwithstanding the theory of frustration of purpose discussed previously, generally in those countries, parties are expected to be thorough and precise about any eventualities that could prompt an excuse of performance or a renegotiation process. As a result, should a change in

circumstances, not predicted by the contract, take place, the affected party usually will have no choice but fulfill its regular duty regardless of how burdensome it may have become.

In civil law systems, on the other hand, legal scholars give greater emphasis to general principles and rules of interpretation formed by law, court decisions and analyses. As a result, courts within those systems rely more heavily on such sources of interpretation for settling contractual disputes, whereas courts in common law countries tend to adhere more strictly to the specific rules agreed to by the parties. Lawyers in Civil Law countries, therefore, tend not to feel obligated to draw an exhaustive list of clear references to all the events that should constitute hardship or not, since it is taken for granted that a judge would instead give precedence to the interpretation of the agreement in accordance with legal principles and norms supplied by then national state.

Arbitral courts, in matters of hardship and *force majeure* in international investment contracts, are usually very cautious and conservative in assessing whether a set of events or circumstances can be considered unforeseeable (Berger, 2009). This stems from the fact that parties in such agreements ought to be seen as professionals that are supposed to employ due diligence and expertise in the evaluation of the possible risks and returns of an investment project. Moreover, risk is an inherent factor in any commercial endeavor and, as posited previously, may be more pronounced in cross-border undertakings. In this line of thinking, the arbitrators in the ICC Award Nº 2142 (1974) stated the following:

> Parties entering into international contracts cannot claim unawareness of the risks or macro-economic adversities. Their effects may be extreme, but are nonetheless within the contemplation of financiers who evaluate the reliability

of borrowers on the strength of contractual undertakings; and as they are in the contemplation of insurers who assess their willingness to provide cover to investors who also relay on such undertakings.

Extreme instances test the very fabric of the myriad of contracts, which are part of the foundation of international economic exchanges. It is precisely at the extremes that the test is meaningful. An international tribunal cannot disregard legitimate contractual expectations without risking harm to this fabric. Arbitrators have no more business sacrificing legal principle to perceive factual realism than a national court can disregard contractual entitlements because it has the impression that the debtor cannot factually meet is obligations. (ICC Award Nº 2142 [1974])

The award is an example within a vast aggregate of arbitral decisions, concerning hardship and *force* majeure, where the court dismissed allegations that a certain set of events had been unforeseeable. It is indeed far easier a task to find such examples in arbitral literature than it is to evince an award in which the court agreed to the claim of unforeseeability of events by an unperforming party (Zaccaria, 2004).

In his research on the topic, Fucci (2006) alluded to some circumstances that were generally not considered to be unforeseeable in arbitral decisions. Some of those were:

1. Substantial changes in asking prices for a product in the market;

2. Adverse economic situations in a country;

3. Acute currency fluctuations;

4. Lack of authorization by a central bank to pay in foreign currency, if exchange control was in place at the time of contracting; and

5. Armed conflicts between countries with a history of hostility.

As such examples in arbitral literature demonstrate, even a change of circumstances of an extreme nature may be seen as foreseeable by arbitral courts and, therefore, not constitute legitimate causes for invoking *force majeure* or hardship.

As previously mentioned, in both the Petrobras and the TGN cases, courts have not considered the radically altered macroeconomic scenario to be unforeseeable. In the ruling against the Argentine Republic, the tribunal found that the presence of adjustment mechanisms and investment assurances in the contract (which Argentina sought to nullify) was evidence enough that risks had been not only foreseeable, but actually foresaw. Regarding the interim judicial ruling in the Petrobras case, the judge commented that the parties had not included, in their contract, contingency payments in case of decreased revenues by accident, but rather, consciously provided for a hypothetical set of events that, as it turns out, came to fruition.

In another example, centered on investments in the Indonesian electricity sector in the 1990s, in an arbitral case ruled by Indonesian law, it was shown how restrictive and strict arbitrators tend to be in the assessment of the foreseeability of events. A state-owned company called PLN requested permission to review an agreement, signed in 1994, with the foreign-owned consortium Karaha Bodas, under which the latter would build and operate thermal energy plants and supply electricity to the former for a 30-year period.

In the years of 1997 and 1998, in the context of the Asian economic crisis, three presidential decrees greatly reduced PLN’s mandate to continue investing in the project. Following this, Karaha Bodas asked, through arbitration, termination of

the contract and compensation for the sunken investments and lost profits. In its defense, PLN, among other claims, pointed to “unprecedented” financial distress caused by the situation in Indonesia, in which there had been a 15% contraction in the GDP; 5 million job losses; an 80% devaluation of the currency and a 75% inflation rate (Girsberger & Zapolskis, 2012). In spite of the admittedly harsh macroeconomic environment, the tribunal dismissed PLN’s allegations as legitimate justification for lack of performance, due to the fact that Indonesia had been, in recent history, plagued by several instances of serious economic difficulties and therefore such adverse scenario could not be considered unforeseeable.

In regard to the change in market conditions as an acceptable cause for the modification of the contract under the hardship excuse, arbitral courts have also shown reticence and conservativeness. Once again, this derives from the assumption that businesses are professional entities that operate under the threat of many forms of risks, some of these related to the market. An emblematic instance in this matter is the ICC Case Nº 8486/1996. The court decided over a dispute between a Dutch manufacturer of machinery and a Turkish buyer that operated in its domestic processed sugar market. In the case, the Turkish buyer had ordered a custom-made sugar-processing plant, for which it would have to pay 5% of the sales price one year before delivery and the rest, by means of an irrevocable letter of credit two months before delivery. However, owing to alleged financial difficulties caused by a dramatic drop in sugar-cube market prices, the buyer only paid 3%, instead of 5%, and did not open the letter of credit on the agreed time. The seller, then, proposed to deliver half of the plant, for an equivalent discounted price, which the buyer agreed to. Subsequently, however, the buyer proposed to pay only 60% of the reduced price and, with the manufacturer’s refusal, an arbitral claim was initiated.

The contract was governed by Dutch law, which provided that a commercial agreement could only be modified by a judge if affected by unforeseen circumstances of such nature that the parties could not be expected to carry it on in an unmodified form (Burgerlijk Wetboek book 6). In its claim, the Dutch manufacturer asserted its right to request full payment, under the original contract, plus interests and legal fees. The Turkish buyer, on other hand, asked to be discharged of its financial obligations, based on the significant reduction of the price of sugar-cubes in the domestic market, or, alternatively, to be granted a more favorable price for the processing plant. The arbitrator asserted that, under Dutch law and legal practice, contracts were only modified in extreme cases and, since the buyer based its defense solely on the reduction of market prices, through the increase of the manufacturing segment, termination or adaptation of the contract was not granted. Fluctuation of market prices, even if severe, due to an increase in competition was deemed to be part of regular risks businesses assume in their regular activities and therefore could not be described as unforeseeable.

The outbreak of war between two nations is a classical example of an event that may lead to a change in circumstances amounting to *force majeure* or hardship. Declaration of war may, for instance, turn performance of a contract between two parties that are domiciled in enemy-nations into an illegal act, such as in the English Trading with The Enemy Act of 1939 (Murray, Holloway, & Timson-Hunt, 2007). Severe price fluctuation or scarcity of supply may ensue from war and cause performance of a given contract to be extremely burdensome to one of the parties, thus allowing the affected party to claim hardship if the contract or the law provides for it. However, the requirement remains that the events leading to hardship be

unforeseeable by the parties and, clearly, not every armed conflict, and its consequences, can be reasonably considered unforeseeable.

In this regard, international arbitration has shown particular reluctance in recognizing hardship in the performance of a contract directly affected by a state of war between two countries with a persistent history of antagonism (Fucci, 2006). One case that illustrates this point is that of a Pakistani bank that refused to pay off a guarantee that was provided in a sales contract. The bank had committed to pay 94 Pakistani Rupees to an Indian cement company for every ton of material that a supplier did not deliver. One year after the conclusion of the contract, the Second Kashmir War between India and Pakistan started, and in the latter country an emergency decree was passed banning all commercial transactions and payments between both nations. When the goods were not delivered, the Pakistani bank did not make the guarantee payments and declared itself excused from the performance of its obligations, under Indian law, due to the government action.

The dispute was taken to arbitration and the sole arbitrator Dr. Pierre Lalive found the *force majeure* claim inadmissible and awarded compensation to be paid to the buyer[46]. The arbitrator considered that a state of war between India and Pakistan, given the history of constant military tension and then recent escalation of hostilities, was not unpredictable, and thus did not satisfy the requirement of unforeseeability for the *force majeure* claim. On the acceptability of *force majeure* in international contracts, Dr. Lalive stated the following:

> As a general rule, one should be particularly reluctant to accept it when there is no gap or lacuna in the contract and when the intent of the parties has been clearly expressed, as in the Bank Guarantee. Caution is specially called for,

46

> moreover in international transactions where it is generally much less likely that the parties have been unaware of the risk of a remote contingency or unable to formulate precisely. (ICC Award Nº 1512 [1971])

The award exemplifies the restrictiveness with which arbitrators tend to interpret *force majeure* and hardship in long-term international contracts. Parties who engage in these types of agreement do so willingly, expecting gains of some sort and should be aware of the risks (Simon, 2012).

In spite of the difficulty in proving the unforeseeability of events in a hardship claim in an arbitration proceeding, there are legal texts and cases that illustrate circumstances that have been considered to be reasonably unforeseeable. The commentary section of Article 6.2.2 in the Unidroit Principles, for instance, gives the following illustration for an event "that could not reasonably have been taken into account". It determines that:

> In a sales contract between A and B the price is expressed in the currency of country X, a currency the value of which was already depreciating slowly against other major currencies before the conclusion of the contract. One month thereafter a political crisis in country X leads to a massive devaluation of its currency of the order of 80%. 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 (UNIDROIT Principles 2010).

The section above aims to provide a practical insight on what sort of events the Unidroit Principles consider to generally afford a hardship claim (provided the other requirements are present). As seen, the text clarifies that an abrupt decrease

of 80% in the value of a currency, in which a contract is denominated, even if gradual devaluation had been taken place, should be considered unforeseeable. Therefore, if the parties of an international contract decide that an arbitral court should resolve their disputes in accordance with the Unidroit Principles, a situation equivalent to the one described in the commentary section will most likely be interpreted as hardship.

Nevertheless, the point remains that it is often a difficult task to consubstantiate a hardship claim in international arbitration with evidence that the events leading up the *status quo* were indeed unforeseeable. This may be seen as a positive fact for investors and lenders as they seek legal certainty and predictability in their investment forays across the globe. It should be noted, however, that although international arbitration courts seem to be very reluctant in overcoming the principle of the ‘sanctity of the contract’, this may not necessarily be true with domestic courts, especially in developing markets, for which arbitration clauses should usually be preferred in cases where large sums of money are invested.

Parties to a contract regulated by an arbitration clause should also consider the issue of enforceability of arbitral awards by domestic courts in cases of failure by one party to observe the arbitral ruling. The Convention on the Recognition and Enforcement of Foreign Arbitral awards (New York Convention, 1958), considered to be a foundational stone for international arbitration, requires contracting nations to uphold arbitral awards made in other contracting states and has been adopted by 149 nations around the world. Within the framework of the convention, domestic courts must enforce arbitral decisions and the parties can only appeal from the award in a limited set of circumstances, regarding formal and procedural aspects of the arbitration process (van den Berg, 2009).

3.3 Excessive Onerousness

Another central issue in the assessment of hardship is related to the dimensions of the burden imposed on the affected party. As stated before, neither the Unidroit Principles nor international arbitral practice consider that the increase of onerousness in the performance of the contract by itself allows for an exemption under the hardship clause. As the Principles point out, a 'fundamental alteration of the equilibrium of the contract' is required for the acceptance of a hardship claim, or as some authors call it, a 'limit of sacrifice' (Bonell, 2007) or 'une rigueur injuste'. Therefore, it is necessary to examine what is deemed to be a minimum level of onerousness for the hardship claim.

The stipulations contained in the UNIDROIT Principles possess a general descriptive character. In this manner, within the section devoted to the hardship phenomenon, there is a focus on drawing conceptual characteristics and general requirements, instead of an exhaustive list of circumstances and eventualities that the makers of the Principles believe would award a hardship excuse. Still, as a means to provide some illustration to the main concepts described in the Principles, some hypothetical examples are shown. In some of these examples, the reader is allowed a glimpse of what may be interpreted as 'excessively onerous' to the point where an adaptation based on hardship would be permitted.

As mentioned previously, in earlier drafts of the Unidroit Principles, one illustration present in the Comment section expressed that, in cases where a precise monetary assessment is possible and key to the allegation of hardship, a 50% increase in the cost of performing or decrease in the value received would be enough to characterize hardship (taking into account the other requirements). However, this hypothesis suffered heavy criticism from both scholars and legal

practitioners, who decried the suggestion as being overly specific (Girsberger & Zapolskis, 2012). Therefore, in order to placate the criticism and approximate itself from real-world practice, the aforementioned example was removed from later editions.

Nevertheless, in discussing the shift in the economic balance of a given international contract, the comment section of the UPICC still provides examples where a hardship claim may be justified. In one of these examples, company A enters into a four-year contract with company B, a waste-disposal service provider in country X. The contract provides that a fixed price is paid per ton of waste disposed by company B. However, by the end of the second year of contract, a new environmental law is passed in country X, making company B’s disposal of waste ten times more expensive. In that situation, according to the UPICC, if all the other requirements were fulfilled, company B would be entitled to a readjustment of the contract due to hardship (UNIDROIT, 2010). Thereby, the official commenters in the Unidroit Principles, vow that, objectively, a ten-times increase in the cost of performance would be considered extraordinarily onerous for the affected party.

In another example, the Principles (2010) avail that a sudden disappearance of the market for the goods or services that in the center of a given contract may be deemed as too onerous of a situation for the affected party. In this interesting example, the cause for such a drastic occurrence was the sudden reunification of a country where, previously, two domestic markets with radically distinct levels of sophistication existed. It is worth noting that the example in question referred to a virtual elimination of demand rather than a simple contraction in the market (Fucci, 2006), thus denoting the extreme character of the onerousness required for the hardship event.

In addition to the official commentary, specialized authors provide a wide range of hypotheses that could amount to a fundamental shift in the balance of the international contract, and therefore, should characterize hardship. Some authors point to situations where such a rigor is created that the affected party ends up receiving no performance at all in return for the fulfillment of its own obligations (Lesguillons, 1995). Another common scholarly approach is that, in the occasions where there is significant risk of financial ruin for the disadvantaged party, a hardship excuse should be granted - observed all the other requirements (Girsberger & Zapolskis, 2012). Furthermore, even cases of lost opportunities by the affected party (Girsberger & Zapolskis, 2012) or windfall gains by the opposing party (Kull, 1991) are sometimes seen as contractual imbalances possibly amounting to hardship.

In spite of the opinions of specialized authors, international arbitral practice has demonstrated a more restrictive approach in recognizing 'excessive onerousness' (Fucci, 2006). In fact, whereas scholars seem favorable to the expansion of the application of the hardship concept in international trade as means to ensuring the viability of long-term contracts, arbitrators have shown a greater tendency to uphold the 'Pacta Sunt Servanda' Principle in a stricter way. In fact, even the standards that can be inferred from the official comment section of the UPICC have not necessarily been followed in arbitral awards that utilize the Unidroit Principles as a source of interpretation (Berger, 2009).

In the aforementioned PLN case, the arbitral court did not accede to the plea from a state company in the electricity sector asking for renegotiation of its agreement with a foreign consortium. Even in view of a deep contraction in the economy (-15%), extreme inflation (75%) and devaluation of the local currency (80%) in the period of one year, the court observed that derogation of contractual

clauses was reserved for 'extreme' cases only. Likewise, in the CMS Gas vs. Argentina case, the tribunal asserted that the crisis in that country could not be deemed as severe as to permit the dissolution of contracts between the government and foreign investors.

In another arbitral award by the International Chamber of Commerce (ICC), though ruled by the CISG, the tribunal, incidentally, analyzed the issue of excessive onerousness. In that case, an European sweets producer demanded restitution from an Ecuadorian commodity exporter on account that the latter had failed to deliver 300 metric tons of cocoa, as was contractually stipulated (*Mediterraneo Confectionary Associates Inc. v. Equatoriana Commodity Exporters S. A.,* International Chamber of Commerce, Case No. 8128, 1995). The defendant, that, in addition to selling the product, was also a producer of cocoa, alleged that it was incapable of delivering the commodity because of an export-ban decreed by the Ecuadorian government. The decree was a response to the severe weather patterns that had vanquished a large portion of the Ecuadorian crops of cocoa, and was aimed at securing supply for the national manufacturers.

The court found that, in spite of the defendant's claims, the obligation had not been made impossible, and therefore, it should have been fulfilled. In the award, the court observed that the contract in question provided that the buyer expected regular delivery of the commodity, and that there was no specification regarding the origin of the produce or that it should have been harvested in the seller's own property. Since it was not considered relevant by the buyer that the cocoa should had come from Ecuador, the seller had the option of purchasing the commodity from another producer in a different country in order to keep its part of the agreement.

The arbitral court argued that the seller was a well-connected commodity trader in the region and, as such, would have been able to procure the same product, in the required quantity, in neighboring countries in order to honor the agreement. In regard to the allegation by the seller that the purchase of cocoa in another country for the resale would amount to excessive onerousness, the court dismissively countered that a reduction in the profit margin of the defendant, albeit of a great proportion, could not be classified as such. Finally, the seller was ordered to pay a pecuniary restitution to the buyer, who had to employ the services of another seller in an alternative purchase order.

The ICC's decision embodied the court's expectation that parties should do the utmost in their power to fulfill their duties in contract. As a testament to the adherence to the Pacta Sunt Servanda Principle by the court, the cocoa exporter was fully expected to deliver the promised goods even if doing so would require employing unexpected resources and pursuing action outside of the normal course of business. It can also be concluded that, to the court, the temporary erosion of profitability in a long-term contract, unexpected and unpleasant though it may be, is a normal risk of conducting business activities.

In the previously mentioned controversy involving Petrobras and the companies MPX Energia and El Paso, the interim decision made by the central court of Rio de Janeiro was partly based on an assessment regarding the issue of excessive onerousness. In requesting the court's permission to make the contingency payments owed to El Paso and MPX Energia in the form of an escrow, as part of its attempt to renegotiate the payments, Petrobras complained that an 'excessive onerousness' was being endured by the company and its investors, on account of the rapid decrease in energy prices. The company estimated, in fact, that

its gas and power department had experienced losses totaling R$ 1.6 billion in 2003 (approximately, R$ 3.0 billion in 2014, or US$ 1.33 billion), mostly because of the contingency payments.

The court in Rio de Janeiro acknowledged that the losses experienced by Petrobras were indeed nominally large, but did not interpret the case as a manifestation of 'excessive onerousness', as the company had hoped. As a matter of fact, the court pointed out that, although substantial, the amount was only a small portion of the annual revenues received by the company, which had cashed in over R$ 17.0 billion in net income in 2004. The conclusion was that, although the expenses from the payments might have turned out greater than initially hoped, they did not pose a threat to such a huge and profitable enterprise.

With the reconciliation between the parties, the Petrobras affair did not reach the arbitral courts. Regardless, the view espoused by that domestic court on the issue of excessive onerousness, or fundamental change in the balance of the contract, coincides with a concept that can be consistently evinced from arbitral literature, that is, that a subjective analysis to the matter of onerousness must be undertaken (Fucci, 2006). That line of reasoning, which is also present in the cocoa-exporting case above, in concrete terms, reflects the notion that an event that may have disastrous consequences in the case of continued performance by a small company, may only result in burdensome, but bearable circumstances for a larger, well-funded enterprise. In that sense, the conclusions seems to be that the affected contract must amount to a large portion of the affected party's business, for a situation of 'excessive onerousness' to be characterized.

Clearly, the viewpoint observed in arbitral literature, pertaining the issue discussed in this section, stands in stark contrast with the positioning of the Unidroit

Principles, when applied to the matter of hardship. The UPICC offers an objective approach, through which the question of performance of an obligation ought to be analyzed in relation to a factual increase in costs or decrease in the value relevant to the affected party. Such a divergence, and the scarcity of awards that deal in a purely objective fashion in relation to the issue of onerousness, is rather perplexing in light of the acclaim generally dispensed to the Unidroit Principles.

In order to avoid any unintended consequences from the application of the UPPIC, or from any other legal source, in an international contract, parties are advised to take preemptive caution in the drafting stage of their contracts. In the Petrobras case, for instance, the company seemingly did not have the foresight that energy spot prices could be reduced drastically if the drought situation was suddenly reversed in Brazil. Alternatively, the company assumed the risk of that significant shift in the balance of the contract, only to regret it later, with the costs of contingency payments. Some measures that could have prevented the financial (and reputational) losses of Petrobras in the drafting-phase of the contract are suggested as follows:

1. A stipulation to the effect that a progressively-discounted amount of the contingency value would be paid, in the event that spot energy prices fall below a certain limit;

2. Under the same circumstances of the previous disposition, Petrobras would guarantee full payment until a certain limit, and extend the contract for the duration of the period in which energy prices are below that threshold;

3. A renegotiation clause to be automatically activated if energy prices reach below a certain level. In this case, standards for the renegotiation process may established.

In the dispute between the cocoa producer and trader and the European buyer, some opportune contractual clauses, as well as better planning by the Ecuadorian company, could have worked to avert the conflict. Excusatory circumstances could have been provided for in the contract (such as adverse weather conditions or legislative changes) and a *délai de grâce* or premium payments could have been required if the events forced the seller to purchase and ship the product from a country other than his. Also, as in the Petrobras case, an amicable renegotiation clause could have been established in the contract.

The research on the matter of excessive onerousness as a factor for the hardship clause seems to attest to a certain contrast between the understanding contained in arbitral awards, the propositions of specialized authors and soft law. Though it is no easy task to produce precise parameters for the evaluation of what would constitute excessive onerousness, it is shown that arbitral courts tend to have a stricter interpretation. As such, parties should strive to indicate as precisely as possible the thresholds of this 'rigueur injuste' that would provoke an adaptation of the contract due to hardship.

3.4 Externality

Another point of practical interest is that regarding the requirement of an external character for the events causing hardship. Indeed, as discussed before, a party may not require renegotiation of the contract under the hardship excuse if the relevant circumstances were brought about by its own actions (or inaction) or could have been reasonably prevented. Though the issue warrants little discussion in the realm of international contracts between private parties, arbitral and judicial practice

referring to contracts in which a state entity is involved have given poignant conclusions that should be of interest to both private and public investors.

In the legal systems that recognize their legal status, both hardship and *force majeure* require that the causing events be beyond the control of the affected party. For private parties in international trade (commercial enterprises or other agents and recipients of foreign investment), effectively, excuses related to factors that are internal to one's structure and functioning do not provide, as a rule, appropriate ground for a hardship claim. Thus,

> internal excuses connected with business operations, general management of the company, financial structuring of the activities or social management of the undertaking, will probably never be accepted as events beyond the control of that part. (Kessedjian, 2005)

As such, occurrences such as the interruption of activities due to strike or failure to perform because of unexpected leveraging issues are not seen as reasonable causes for the acceptance of a hardship or *force majeure* claim. However, it should be noted that when such events have a widespread character, as in the case of a countrywide general strike or insolvency caused by state-led expropriation of assets, then it would be reasonable to assume an externality of the relevant events.

In the matter of international investment contracts involving state entities, an important discussion arises. Should an act by the government, that owns or has a controlling stake in the contracting party, be considered an external event in relation to the latter?

It is important to note that there isn't scarcely any published arbitral awards that discuss this issue in a controversy about hardship (Fucci, 2006). On the other

hand, quite a few cases related to the allegation of *force majeure* due to governmental policy could be found. As the requirement of 'externality' of events is interpreted almost identically in *force majeure* investigations as in hardship inquiries, it seems adequate to investigate the positioning taken by arbitral courts in those instances.

There are a variety of published awards, in cases concerning different sectors of the economy, in which a request by a state enterprise for a declaration of *force majeure,* due to governmental acts, was rejected. The fact is that arbitral courts often express skepticism about allegations of *force majeure* in those cases since, it is argued, policies undertaken by the government and acts by the affected state company have as source the same decisional power. In that line, Berger (2009), in a reference to state companies, asserts that, 'in a similar fashion to piercing the corporate veil, they are regarded as an integral component of the state which is responsible for the change on conditions in the host country'. Therefore, according to this reasoning, in instances of negative consequences caused by governmental acts, the formal distinction between the two legal entities should be blurred and, in this way, no *force majeure* or hardship case should be recognized in court.

In an arbitral case submitted to the ICC (ICC Case No. 6465), the court decided that the parenting government of a state entity was liable for its actions due to evidence of the existence of an over-arching control by the latter. In the award, the court expressed the following:

> [The State entity] by its purpose and through its operations almost totally served as a vehicle to meet the needs and requirements of the X Government, in particular its military forces. [The State entity] was almost completely controlled by and dependent on the X Government's decisions,

> and the Government exercised its powers to such a degree that [the State entity] must be seen as an instrumentality of, or agent for, the X Government. (ICC Case No. 6465, Aug. 15, 1991 Interim Award)

As a consequence of that assessment, consistently adopted by the ICC, in regard to the state entity as a 'instrumentality' of the parent government, that court produced numerous awards to the effect that: 1. Acts of a state entity were attributed to its parent state; 2. Claims by state companies that their non-performance, caused by governmental action, constituted *force majeure* were rejected (Gaillard & Younan, 2008).

There are several arbitral awards published by the ICC that demonstrate the viewpoint stated above. In one case, a foreign contractor demanded compensatory payment because of the sudden termination of a construction project that was the object of a contract it had with a state company (ICC Case No. 6465, Aug. 15, 1991). The project was discontinued due to a legal act by the government as part of a change in public policy that effectively prevented the state company from performing in the contract. Though a *force majeure* claim was made by the state entity, the court took the view that the latter was 'instrumentality' of state policy and, therefore, the governmental act did not qualify as being beyond its control.

In another case, involving the sale of refined oil products and crude oil, the Algerian seller demanded compensation plus interests for the merchandise that was delivered, but whose corresponding invoices were not paid on time by the buyer, a state company from another African country (ICC Case No. 3099, May 15, 1979). The buyer admitted to its liability for the unpaid principal, but declared that the payment of interests was not justifiable as, at the time of the transaction, the company was not allowed access to sufficient foreign currency by its central bank,

and therefore, was unable to honor the debt in its entirety. The tribunal, citing the fact that 70% of the purchasing company's capital belonged to the state, and that half of its executives were also appointed by the government, concluded that, since the executive branch of that state exercised power over both the central bank and the company in question, the denial of foreign currency by the former could not be interpreted as a *force majeure* event.

In the opposite sense, Fucci (2009) cites several cases concerning trading companies from countries belonging to the former soviet block, where the arbitral court in charge concurred that certain events that had impeded the due fulfillment of a state's company contractual duty and that were caused by acts of the central government, were considered 'external' to the parties and, as such, a *force majeure* injunction was accepted. An example of this view is the ICC award that determined that the revocation from a Romanian state company of an export license by its central executive should be seen as beyond the control of the affected enterprise (ICC Award No. 2478, 1974). It seems, therefore, that the issue of 'externality' in the assessment of *force majeure* and hardship is not entirely settled in international arbitration.

As a matter of fact, state companies do posses a distinct legal identity in relation to parent states. As a normal course of proceedings, this separation should be acquiesced by courts and only in specific circumstances, an act by the central authority should be deemed to be within the reach of control by the enterprise. In this sense, former secretary-general of the ICC Court of Arbitration Yves Derains (1980) stated that 'the independence of a public enterprise with respect to the State, just like the independence of a subsidiary with respect to its parent company, must be assessed as a factual question'. Nevertheless, the current trend in this matter in

international arbitration seems to be to disregard the legal separation between the two entities in cases of *force majeure* brought about by the state.

4. Conclusions

The present work sought to investigate the adaptation of the international investment contract, in general; and, specifically, the hardship clause. Upon research, it was found that the matter of adaptation of the contract in the international investment scene has been for many been decades the center of profuse discussion and preoccupation among companies, national states, international organisms, scholars and practitioners. The exponential increase in foreign investment has shed light on the inherent risk and confusion caused by a multitude of legal systems and the application of distinct concepts and rules on the matter of adaptation of the international contract. Indeed, particularly regarding long-term contracts, special attention must be paid by executives, financiers and policymakers to the consequences of unforeseen circumstances that affect the performance of the agreement in a detrimental way,

The hardship clause was approached initially as a useful mechanism for creating flexibility in long-term investment contracts, thus allowing the parties a degree of security in the case of an excessive burden caused by unforeseen circumstances, while also contributing for the preservation of the commercial relationship. Research showed that in the case where contracting parties do wish to incorporate a hardship clause in their agreement, it is not necessary that they do so explicitly. However, in that case it is necessary that a domestic law that recognizes hardship regulate the contract. Parties should be aware of the specific effects of a hardship claim, in accordance to the chosen law. It was also found that in common

law countries, statutory hardship clauses are generally unheard of, and, therefore, parties are advised to deal explicitly with the consequences of unforeseen circumstances in their agreements, lest they must perform their contractual due no matter how onerous it becomes. In Civil Law countries, however, it is common that statutes do provide remedies for the loss of the initial economic 'equilibrium' in the case of hardship. As such, an affected party may be granted renegotiation or termination of its contract, even if no provision to the issue of unforeseen circumstances is dealt with in the agreement.

Literature review also allowed for the conclusion that international arbitral courts tend to have a very restrictive approach in the judgment of hardship claims. This assessment is supported by the greater amount of arbitral awards that were found in which hardship claims were rejected in comparison to cases where the hardship excuse was granted. This is generally very positive for financiers and investors that demand stability in foreign undertakings, particularly in dealing with governments and state enterprises. The study also evidenced that international commercial practice still lacks a solid and common standard for the assessment of cases where a 'fundamental shift in the economic balance of the contract' is claimed. The other requirements for the acceptance of a hardship claim also remain deeply subjective, prone to interpretation and circumstantial. Likewise, objective standards are also lacking for what could be a 'fair distribution of losses' in the readjustment of an agreement by a third-party. Given this state of unpredictability and lack of solid international standards, parties should strive as much as possible to provide for circumstances and shifts in relevant factors, while at the drafting stage of the agreement. To that effect, automatic adaptation clauses, such as those dealing with decreases in price or increases in costs, seem to be an effective form of ensuring

predictability while at the same providing a degree of flexibility to the duties in the contract. It also seem advisable that in the cases where parties agree on a renegotiation mechanism due to unforeseen circumstances, certain minimum standards and rules should be preemptively provided in the contract both for the procedure and for a possible adaptation.

It should be noted that the study was constricted by certain limitations. The most important of these is related to the absence of a large database of published arbitral awards that deal with the issue of hardship. This derives from the fact that parties in international arbitration cases often choose to enclose in secrecy the proceedings and the ensuing awards. As a consequence, it may be that, with a larger sample, the veracity of the generalizations proposed in this study would not be sustained.

In addition, the Unidroit Principles constantly referenced in this paper and widely merited as extremely influential in the harmonization of rules concerning international trade, are relatively recent in their inception. Therefore, it may be argued that scholarship and arbitral literature have not yet formed a common pool of interpretative results, for which the interpretation of international contracts in accordance to the UPICC can still be fraught with a degree of uncertainty.

As an expansion of the present study and a suggestion for future research, an empirical analysis concerning the matter of readjustment of contracts, adaptation clauses and the hardship clause would certainly be of interest to the business community. This investigation could attempt to correlate the impact of selecting one the different types of adjustment mechanisms on economic variables. Such a study, discriminating distinct sectors of the economy, could indicate more concrete causal relationships and provide decision makers with an important strategic resource.

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