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# About Grounds for Exemption from Performance under the Draft Estonian Law of Obligations Act (*Pacta Sunt Servanda versus Clausula Rebus sic Stantibus*)

The sacred principle of the classical law of obligations was the idea of *pacta sunt servanda* (sanctity of contracts), which means that contracts are binding on any conditions. According to the classical theory of contracts, each reasonable person has the freedom to enter into a contract upon terms determined by that person and to be certain that a contract concluded voluntarily will be subject to judicial enforcement and binding on the parties. It is primarily in the public interest to hold contractual agreements binding under any circumstances. Everyone's freedom to decide whether to conclude a contract (*Abschlussfreiheit*) and to decide about the content of the contract (*Inhaltsfreiheit*), in addition to honesty in the process of entering into a contract, were to preclude unfairness in contractual relationships. Disputing of contracts was allowable if the contract had been concluded by fraud, mistake or duress. In the absence of those circumstances, the parties were bound to their contract. Unilateral denunciation of a contract was, therefore, in general, excluded.\*<sup>1</sup>

The very same principles, characteristic of the classical contract law, also served as a basis for drafting the Estonian Civil Code (ECC)\*<sup>2</sup>, applicable from 1 January 1965. Hence, in accordance with ECC section 174, unilateral refusal to perform an obligation or unilateral modification of contractual terms are not permitted, except in the cases prescribed by law.

The *Riigikogu* (Estonian parliament) is presently reading the draft Law of Obligations Act (LOA)\*<sup>3</sup>, which will replace the obligations part of the 1965 Civil Code. The applicable Estonian civil law contains no provisions to regulate the general grounds and procedure for unilateral withdrawal from a contract or for claiming specific performance from a party in breach or for exemption from

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<sup>1</sup> R. Zimmermann. *The Law of Obligations. Roman Foundations of the Civilian Tradition*. Deventer, Boston: Kluwer Law and Taxation Publishers, 1992, pp. 576–577.

<sup>2</sup> Eesti NSV Tsiviilkoodeks. III osa. Kohustusõigus (The Civil Code of the Estonian SSR. Part III. Law of Obligations), adopted on 12.06.1964; entered into force 1 January 1965 (in Estonian)

<sup>3</sup> Võlaõigusseaduse eelnõu (The draft Law of Obligations Act) (116 SE II-2 of 10 January 2001). Available at: <http://www.riigikogu.ee/ems/index.html>, 20.06.2001 (in Estonian).

performance. Changes to accompany the adoption of the Law of Obligations Act in contract law are, therefore, of fundamental importance, as principles substantially different from those of the applicable law will be provided in respect of the consequences of breach of the duty to perform and with regard to the permissibility of claiming specific performance. While the applicable law, as well as judicial practice, observes, quite strictly, the principles of *pacta sunt servanda*, the draft Law of Obligations Act contains provisions, which are rather based on the principle of *clausula rebus sic stantibus*. It is yet difficult to predict the consequences of this new and considerably more flexible regulation for Estonian legal practice and economy. However, it can be stated with certainty that the new regulation will require a different approach to the binding nature of contracts both from judges as well as advocates, who will be protecting the interests of their clients on the basis of the new Act.

## Principle of *pacta sunt servanda* in modern contract law

The principle of *pacta sunt servanda* has always had its limits. Even in Roman law, no contract was absolutely binding or binding under all circumstances. Unilateral dissolution of the contract was permissible if a party failed to perform its contractual obligations (e.g. in the case of leases, mandates or contracts of sale). Another known basis for dissolution of contracts was *laesio enormis*, i.e. the right to dissolve a contract of sale if a plot of land had been sold at a price below its actual value. Pandectists allowed dissolution only in the event of breach of contract. That rule was established by canon law, adopted by followers of natural law and, eventually, it found its way to *BGB* (*Bürgerliches Gesetzbuch* — the German Civil Code). Nowadays, statutory rights of withdrawal from a contract have been granted in the interest of consumer protection.<sup>\*4</sup>

Historically, the principle of *pacta sunt servanda* has been prejudiced by the principle known as the doctrine of *clausula rebus sic stantibus*. According to that doctrine, a contract is binding only in so far as the circumstances remain the same as at the time of the conclusion of the contract. That principle can be used to erode the binding nature of contractual promises, and thereby it substantially prejudices the *pacta sunt servanda* principle. The *clausula* doctrine fell into oblivion at the end of the 18<sup>th</sup> century and the beginning of the 19<sup>th</sup> century, when classical contract law, liberal economy and legal certainty were declared to be of superior value. Moralists philosophers were the first to draw attention to changes in the circumstances, thus laying a foundation to the recognition of the *clausula* principle.<sup>\*5</sup>

In the modern theory of contracts, two types of fundamental views can be found. Some authors maintain that modern contract law cannot be based on the positions of classical contract law any more, since those positions have inevitably become inappropriate in the light of the economic and philosophical developments. Others are trying to demonstrate that contract law has become increasingly relational in modern days. Contract law is studied from the aspects of several fields, and analysts are now interested not only in the legal but also the social, economic and philosophical aspects of contracts. Contract law has developed beyond the legal and economic spheres of interest, now also encompassing the social aspects. The efficiency of legal regulation and the development of legal policy are evaluated from the aspects of several disciplines and on the basis of the comprehensiveness of regulation. Hence the economic and social consequences and fundamental problems, rather than the legal aspects of legal regulation, seem to be the main focus in modern-day contract law.<sup>\*6</sup>

One such fundamental problem, which has become topical every so often throughout history, is the question of those circumstances whereunder contractual agreements should be binding on the parties and of when parties to a contract may be discharged from performance.

It was already stated by St. Thomas Aquinas that failure to keep promises was not a sin in the event of a change in circumstances, and Bartolus of Saxoferrato introduced the idea of implied condition — *rebus sic se habentibus* — for all kinds of possible transactions.<sup>\*7</sup> The 17<sup>th</sup> century was a favourable period for the *clausula* doctrine, which was accordant with the predominant political situation of that time. The principle of *clausula rebus sic stantibus* first became a respectable doctrine in international

<sup>4</sup> R. Zimmermann (Note 1), pp. 578–579.

<sup>5</sup> *Ibid.*, p. 579.

<sup>6</sup> P. Vincent-Jones. Contractual Governance: Institutional and Organizational Analysis. — Oxford Journal of Legal Studies, 2000, Vol. 20, No. 3, p. 318.

<sup>7</sup> R. Zimmermann (Note 1), p. 580.

law while in private law, its position was not the strongest. The 19<sup>th</sup> century, in contrast, was not most favourable for the recognition of the *clausula* principle. The theory of intention, whereunder a person's intention concerns only certain circumstances and develops on the basis of knowledge and consideration of those circumstances, permitted breach of promises if those circumstances proved to be wrong. On the other hand, it was realised that the society's interest in ensuring legal certainty, guaranteed by ensuring a balance of interests between the contracting parties, was also worth protection. In particular, Windscheid's doctrine of tacit presupposition (*Voraussetzungslehre*)\*<sup>8</sup> was one of the attempts to ensure balance in contractual relationships, especially as that theory was based on the presumption that contracting parties plan the realisation of legal consequences under certain specific circumstances. Usually, the presumption that certain circumstances will remain unchanged is not a direct condition of a contract. If the presumption of unchanged circumstances, as considered at the time of concluding the contract, proves to be wrong, requirement of performance may be unfair and unreasonable, taking, however, into account that the promisee must have understood that the other party had been influenced by certain circumstances. In such event, the promisor should have the right to demand termination of the contract. For that reason, Windscheid's theory has been regarded to be close to the theory of conditional contracts, which is based on the condition that the circumstances remain unchanged during the entire life of the contract.\*<sup>9</sup>

Windscheid's theory could not be made acceptable to the drafters of the German Civil Code (*BGB*), and therefore, *BGB* does not contain a general rule about changes in the circumstances. However, modern versions of the *clausula* principle have been developed *extra legem* by courts and jurists.\*<sup>10</sup> An example of this is the frustration theory, the formulation of which became necessary in connection with the economic and political problems caused by the First World War, and, in particular, with regard to performance of long-term contracts influenced by those problems. By now, the *clausula* principle has become a part and parcel of modern German contract law.\*<sup>11</sup>

In common-law countries, the *clausula* doctrine has not exerted any substantial influence on the development of contract law. It was already stated in the case of *Paradine v. Jane* (1647)\*<sup>12</sup> that contractual obligations were absolute and no dissolution thereof was permitted. That principle prevailed in English law until the 19<sup>th</sup> century, when the case of *Taylor v. Caldwell* (1863)\*<sup>13</sup> laid a foundation for the modern *clausula* doctrine.\*<sup>14</sup> Under the traditional common-law rules, parties to a contract were not excused from performance even by such circumstances, following the conclusion of the contract, that made performance impossible, and it was found that the effect of such circumstances on contractual obligations must be foreseen by the parties. That position is also in accordance with the principle of strict liability, which is recognised in common law in respect of contractual relationships.\*<sup>15</sup>

## Grounds for exemption from contractual duties

Regardless of different approaches to the binding nature of contracts, the study of legal grounds for exemption from contractual duties has become very important in modern times. This sphere of problems has become topical because of the increasing number of long-term contracts, which are extremely sensitive to changes and unforeseen circumstances. Moreover, despite the many theories and analyses that have been published in literature, this sphere is still unclear and undefined. What

<sup>8</sup> Windscheid's main work was the monography "Die Lehre des römischen Rechts von der Voraussetzung" (1850). The name of this theory can be translated into English as "the doctrine of contractual assumption", which has been used in T. Weir's translation of the book: *An Introduction to Comparative Law* (2<sup>nd</sup> ed., 1992, p. 557) by K. Zweigert and H. Kötz.

<sup>9</sup> W. Lorenz. *Contract Modification as a Result of Change of Circumstances. Good Faith and Fault in Contract Law*. Ed. by J. Beatson, D. Friedman. Oxford: Clarendon Press, 1997, p. 361.

<sup>10</sup> R. Zimmermann (Note 1), p. 581.

<sup>11</sup> *Ibid.*, p. 582.

<sup>12</sup> *Paradine v. Jane* (1647) Aleyn 26; 82 ER 579, 897.

<sup>13</sup> *Taylor v. Caldwell* (1863) 3 B&S 826, 835; 122 ER 309, 313, per Blackburn J.

<sup>14</sup> However, the case of *Taylor v. Caldwell* was of decisive importance with regard to reducing differences between civil law and common law. An equitable result was achieved by supplementing the contract with the tacit presupposition that the circumstances would remain the same. The decision adopted in that case was of historical import, paving the way for the later famous cases of coronation festivities.

<sup>15</sup> U. Draetta, R. B. Lake, V. P. Nanda. *Breach and Adaption of International Contracts. An Introduction to Lex Mercatoria*. New Hampshire: Butterworth Legal Publishers, 1992, p. 87.

are, then, those unforeseen circumstances whereupon a party may be discharged from its duties or render a performance which is substantially different from the initial agreement?\*<sup>16</sup>

In modern legal systems, the theory of frustration (*Wegfall der Geschäftsgrundlage*) is recognised as a basis for exemption from contractual duties. Frustration may arise upon delay in performance or extinguishment of the *causa* of the contract (death of a person, destruction of a thing, *etc.*), or if performance becomes illegal, or upon a material change in the circumstances, whereby the initial contract transforms into another contract, *i.e.* it becomes substantially different from what was agreed initially, or upon a bilateral mistake or for the reason of economic unreasonableness.\*<sup>17</sup> Regardless of the dissimilarities in the classification of circumstances, all of those circumstances have the common consequence of duties becoming excessively onerous. Excessive onerosity itself may be constituted by an increase in the cost of performance or decrease in the value of what is receivable under the contract. Impossibility of performance, dispute against the transaction or recourse to its voidness, impermissibility of claims for performance or excusability of breach may also serve as grounds for exemption, besides substantial difficulties in performance. Hence a distinction must be made between situations in which a party is discharged from performance without the maintenance of any other duties of conduct and situations in which a party's obligation to perform is extinguished but another duty, *e.g.* a duty to pay penalties, is maintained or the initially agreed obligation is reduced or modified.\*<sup>18</sup>

In addition to the above-mentioned cases, each legal system usually provides legal measures for discharge of contracts by unilateral termination. Performance of a contract may become impossible in connection with a change in factual circumstances, establishment of statutory prohibitions or for the reason of economic unreasonableness.\*<sup>19</sup>

According to Windscheid's theory of tacit presupposition, a contract is regarded to be concluded on the inchoate condition that the assumed state of affairs remains unaltered for the period of the contract. This implies a danger that one party may avail itself of the chance to transfer contractual risks to the other party, which would considerably reduce legal certainty and the reliability of economic transactions.\*<sup>20</sup> If Windscheid's theory is applied side by side with Oertmann's theory, whereunder a contract is based on the presumption of the existence or realisation of certain substantial circumstances that have been notified to, or been acquiesced in by, the other party at the time of concluding the contract, it will be possible to move from the hopes of the parties to the obvious effects which the changed circumstances have had on the transaction.\*<sup>21</sup> However, in respect of determining the parties' positions and the permissibility of claims, importance is borne by the changes, arising out of the changed circumstances, in the balance between the duties and rights.

Regardless of the dissimilarity of theoretical conceptions and arguments regarding exemption from contractual duties in different legal systems, possible solutions to the problems are nonetheless related particularly to the question of a reasonable division of risks between the parties.\*<sup>22</sup>

## Impossibility

Impossibility of performance is the most typical case of breach of contract. In old European civil codes, the consequences of impossibility of performance depend on whether or not the party in breach was at fault with regard to the breach. The Continental and Anglo-American legal systems are, however, remarkably different in their positions towards the question of the fault of the party in breach in respect of allowing recourse to remedies. While in Continental civil codes, liability is based

<sup>16</sup> D. Tallon. *Hardship*. – A. Hartkamp, M. Hesselink, E. Hondius, C. Joustra, E. du Perron (Ed.). *Towards European Civil Code*. Nijmegen: Ars Aequi Libri, 1998, p. 327.

<sup>17</sup> W. F. Ebke, B. M. Steinhauer. *The Doctrine of Good Faith in German Contract Law*. *Good Faith and Fault in Contract Law*. Ed. by J. Beatson, D. Friedman. Oxford: Clarendon Press, 1997, p. 180.

<sup>18</sup> B. Markesinis. *The German Law of Obligations*. Vol. I. *The Law of Contracts and Restitution: A Comparative Introduction*. Oxford: Clarendon Press, 1997, p. 519.

<sup>19</sup> G. H. Jones, P. Schlechtriem. *Breach of Contract*. *International Encyclopedia of Comparative Law*. Vol. VII. *Contracts in General*. Chief ed. A. von Mehren. Tübingen: Mohr Siebeck, 1999, pp. 99–100.

<sup>20</sup> B. Markesinis (Note 18), p. 518.

<sup>21</sup> *Ibid.*, pp. 518–519.

<sup>22</sup> G. H. Treitel. *Law of Contract*. 9<sup>th</sup> ed. London: Sweet & Maxwell, 1995, p. 781.

on fault, the so-called strict liability is applied in Anglo-American systems.<sup>\*23</sup> Nor is the conception of impossibility of performance used as a basis for exemption from contractual obligations in the UN Vienna Convention on Contracts for the International Sale of Goods of 1980 (CISG). Cases in which a party cannot perform an obligation due to impossibility of performance are, nevertheless, regarded as breach of contract. The aggrieved party may still claim damages and, if the breach can be regarded as substantial (CISG art. 25), even termination of the contract. Upon breach of contract, the aggrieved or if requirement of performance is permitted (CISG art. 28).<sup>\*24</sup>

The Principles of European Contract Law (PECL) and the Principles of International Commercial Contracts (PICC)<sup>\*25</sup> provide for liability regardless of the fault of the party in breach and regulate the cases in which specific performance cannot be obtained. Thus, according to PICC article 7.2.2 (a) and PECL article 9:102 (2) (a), specific performance cannot be obtained if performance is unlawful or impossible. If the impossibility of performance was not excusable, the aggrieved party is also entitled to damages (PECL art. 9:501 (1); art. 8:108; PICC art. 7.1.7).

The applicable Estonian law is based on the principle that duties are automatically extinguished in the event of impossibility of due performance thereof. In accordance with section 240 of the Estonian Civil Code (ECC), an obligation is extinguished if the impossibility of its performance has been elicited by circumstances beyond the debtor's responsibility. However, if the debtor is responsible for the impossibility of performance, the obligation does not terminate but, instead, only its content changes. If a duty cannot be performed any more, the party in breach must compensate for the damage caused by non-performance. Thus, impossibility of performance through the debtor's fault entitles the creditor to claim recovery of the damage thereby caused. In accordance with ECC section 227, a party in breach of an obligation is liable only upon the existence of culpability (intent or negligence), unless otherwise provided for by the law or stipulated in the contract. The absence of culpability must be proved by the person in breach. Hence, in the applicable law, an obligation is automatically extinguished in the event of impossibility of its performance, and recourse to any remedies is excluded. Claims arising out of the liquidation of an obligation must be filed on the basis of the provisions concerning unjust enrichment, which are, however, patently imperfect under the ECC for the achievement of the desired objective.

The Estonian Law of Obligations Act was drafted on the basis of the general principle that contracts are binding. Thus, in accordance with LOA subsection 8 (2), the performance of a contract is mandatory and, in accordance with subsection 11 (1), the applicability of a contract is not influenced by the fact that performance of the contract was impossible or that the thing or right serving as the object of the contract was not at a party's disposal at the time of concluding the contract.

However, in the draft Estonian Law of Obligations Act, the permissibility of applicable remedies depends on whether the non-performance is excusable or not. Still, recourse to remedies is not absolutely precluded, but only limited by the criterion of excusability.

In accordance with LOA subsection 96 (1), breach of obligation is excusable if the debtor is in breach due to an impediment beyond its control (*force majeure* circumstances). *Force majeure* is constituted by an impediment beyond the control of the debtor, who could not be reasonably expected to consider or prevent such impediment, or overcome the consequence thereof, at the time of concluding the contract or upon the inception of the obligation from tort.<sup>\*26</sup> If the effect of *force majeure* is temporary, the breach is excusable only during the period when performance is impeded by *force majeure* circumstances. In accordance with LOA section 98, the creditor may, regardless of the debtor's liability, withhold the performance of its own duties, unilaterally dissolve or terminate the contract as well as reduce the price. If both parties are engaged in economic or professional activities, the creditor may claim interest, regardless of the debtor's liability for the breach.<sup>\*27</sup> Despite the fact that impossibility of performance is not excusable, the creditor may not require specific performance if performance of the obligation is impossible (LOA subsection 101 (2) 1)). Differently from PECL article 9:102, unlawfulness, unlike impossibility, is not provided as a basis for not permitting claims for specific performance in the draft Estonian Law of Obligations Act. Thus, according to the circumstances, even those cases in which specific performance is prevented by statutory prohibitions have to be qualified as impossibility.

<sup>23</sup> D. Tallon. Breach of Contract and Reparation of Damage. – A. Hartkamp, M. Hesslerink, E. Hondius, C. Joustra, E. du Perron (Ed.). Towards European Civil Code. Nijmegen: Ars Aequi Libri, 1994, pp. 223–224.

<sup>24</sup> G. H. Jones, P. Schlechtriem (Note 19), p. 98.

<sup>25</sup> UNIDROIT Principles of International Commercial Contracts (1994). The Principles of European Contract Law (1998).

<sup>26</sup> The conception of excusability is analysed on the basis of CISG article 79.

<sup>27</sup> The draft Law of Obligations Act (Note 3).

In accordance with LOA subsection 101 (1), claims for specific performance with regard to monetary obligations are always permitted. Nevertheless, introduction of a general regulation similar to PECL article 9:101 (“Monetary Obligations”) should be considered with a view to those cases in which there is a need to justify the impermissibility of claims for specific performance of monetary obligations and to protect the other party against forced performance.

## Frustration

Frustration is regarded to include situations in which performance is possible but the creditor has lost its interest therein. Such loss of interest may arise from different circumstances. For example, performance may become excessively onerous or the value of what is receivable under the contract may become insignificant. Frustration is not deemed to mean a failure to receive the expected benefits from a transaction, since that risk is presumed to be borne by the parties themselves.<sup>\*28</sup>

It has been demonstrated by German judicial practice that even nowadays, intervention in contracts is considered possible by courts, who are ready to make contracts equitable. German practice has also shown that in the case of intervention in contracts, courts prefer frustration to the institutions of impossibility or mistake, as this leaves more room for manoeuvring and finding correct solutions. Whether courts should do this or not is yet another question. Arguments justifying intervention in contractual relationships have emphasised the need to ensure an equitable division of risks between the parties (except in the event of simply a bad transaction) or for the reason that the aggrieved party cannot bear the unfavourable consequence because of its economic situation.<sup>\*29</sup>

In economic activities, the parties themselves must be able to evaluate the circumstances, take account thereof and foresee measures to liquidate or prevent unpleasant consequences. In any event, one should agree with the view that economically unfavourable situations should not be too easily ascertainable and not every economic change should bring about an option to dissolve the binding nature of the contract.<sup>\*30</sup>

One of the most frequent types of frustration involves export restrictions and quotas or the requirement to obtain a licence necessary for the activities. Such contracts often give rise to the question whether the parties have, at the time of concluding the contract, already taken account of the risk that a licence would not be obtained or that the quota would be too small or that export or import prohibitions would be established. In the event of contracts between professional traders, consideration of such circumstances at the time of entering into the contract should be regarded as an inchoate contractual condition and part of the due care.

The applicable Estonian law contains no general provisions to regulate frustration as a legal basis for exemption from contractual obligations or for demanding modification thereof. In accordance with ECC subsection 230 (2), the creditor may refuse to accept performance if it has lost its interest in performance because of a delay. Thus, the debtor may be discharged from its duty to perform if it delays the performance of its absolute obligations. However, the Civil Code contains no provisions that would permit an obligee to refuse to perform its duties if, after the conclusion of the contract, it becomes evident that the other party’s economic situation has deteriorated in comparison with that of the time of concluding the contract and this would jeopardise the reception of counter-performance. Nevertheless, subsection 85 (1) 3) of the General Part of the Civil Code Act<sup>\*31</sup> entitles the creditor to demand security from the debtor if there is reason to believe that the debtor is not capable of performing the obligation arising from the transaction. In addition, ECC sections 248 and 249 entitle the seller and the buyer, respectively, to unilaterally refuse to perform the contract if the counter-party fails to perform its contractual obligations, which serves as a basis for frustration. A lawful right to demand review or modification of contractual terms also arises out of subsection 6 (2) of the Commercial Lease Act, whereunder the lessor may demand review of the rent in the event of change

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<sup>28</sup> W. F. Ebke, B. M. Steinhauer (Note 17), p. 184.

<sup>29</sup> B. Markesinis (Note 18), p. 538.

<sup>30</sup> Usually, in this connection, reference is made to the so-called Suez Canal cases, in which frustration arose out of the closing of the Suez Canal on 2 November 1956 in connection with military activities between Israel and Egypt. The courts found that as the canal had been closed, the suppliers must find a reasonable and equivalent way to transport the goods. That was the seaway around the Cape of Good Hope. In the case of the war between Iraq and Iran, the courts also assumed the position that frustration was not evoked by an outbreak of a war as such but could, rather, result from the effect of the war on the performance of the contract.

<sup>31</sup> Applicable from 1 September 1994.

in such prices, depreciation rates, tariffs or payments that are determined on the national level. As yet, no claims filed on that basis have been satisfied in Estonian judicial practice.

Frustration is, first of all, a question of whether exemption from an obligation should be based on the frustration of a subjective or objective basis. The subjective basis of a transaction includes the circumstances that have been referred to by the parties during the negotiations and that have influenced the parties to enter into the contract. The objective basis means those circumstances that should logically exist in order that the objective of the contract be achieved. In modern times, distinction between the objective and subjective bases is no longer made, and exemption from the duty to perform is possible in either event.<sup>\*32</sup>

In accordance with LOA subsection 101 (2) 2), specific performance may not be claimed if the performance would be excessively onerous or costly for the debtor. If the excessive onerosity results from objective circumstances (non-performance by the debtor would be excusable), such situation may be qualified as an excusable breach of the duty to perform and the creditor may have recourse to remedies provided for excusable breaches on the part of the debtor. Even in such event, claims for specific performance are excluded. Hence LOA subsection 101 (2) 2) is applicable only if performance is yet possible but claims for such performance have become unreasonable due to certain subjective circumstances.

The special part of LOA provides, like section 610 of the German *BGB*, that a person who has promised to give a loan, may withdraw that promise if the economic situation of the borrower has deteriorated to such extent as to cast doubt on the borrower's ability to repay the loan. In Estonian courts, classical examples from German judicial practice can be used to illustrate provisions of law<sup>\*33</sup>, but in respect of specific decisions, consideration of Estonian economic and social climate and consequences will, however, be of conclusive importance.

Frustration may also be constituted by the so-called economic frustration. Thus, for example, hyperinflation substantially influenced German judicial practice in deciding whether or not the parties were bound to their contractual duties. It was found by German courts that in the event of sale contracts, the risk of price changes must be borne by both of the parties. Nevertheless, if this led to economic ruination, contracts should not be binding. In a normal economic situation, however, inflation should naturally not be a sufficient argument for exemption from contractual duties.<sup>\*34</sup> Until now, in Estonian courts, no claims for reduction of or increase in agreed payments on the basis of inflation have been found to be justified.

The German theory of frustration is not so similar to the English-law theory of frustration as, rather, to the doctrine of equitableness recognised in English law, which allows adjustment of contracts in the case of a mistake that has occurred upon the conclusion of the contract. In the event of frustration, the contract terminates automatically and the court has no right to adjust the contract to the changed situation or to make the parties' duties more equitable, except in certain situations of restitution.<sup>\*35</sup>

## Delay

A delay may result in a change in the balance between the parties' duties, in consequence of which the duties become substantially more onerous for one party or the value of what is receivable under the contract diminishes substantially. In the applicable law, ECC subsection 230 (2) provides that if the creditor has lost its interest in performance due to a delay, it may waive performance and claim damages. In accordance with LOA subsection 106 (1), a party may unilaterally dissolve the contract if the other party is in fundamental breach of a contractual duty. Fundamental breach means, *inter alia*, a breach of such duty, strict compliance with which is of the essence of the contract. Fundamental breach with regard to a part of the performance may entitle the party to unilaterally terminate the entire contract if the breach with regard to the part in question was fundamental in respect of the entire contract or if the creditor is uninterested in partial performance. Thus, a delay elicits the right to either refuse to accept performance or to unilaterally dissolve the contract and, hence, to discharge the debtor from the duty to perform.

<sup>32</sup> W. F. Ebke, M. Steinhauer (Note 17), p. 183.

<sup>33</sup> RGZ 57, 116; B. Markesinis (Note 18), p. 521.

<sup>34</sup> B. Markesinis (Note 18), p. 523.

<sup>35</sup> *Ibid.*, pp. 529, 530.

## Adjustment of contractual terms

Modern contract law needs, first of all, answers to questions relating to the proportional preservation of duties and the legal consequences of changes in duties. Since contracts are concluded in order to achieve a certain objective, the parties are usually interested in preserving and adjusting rather than getting rid of the contract even if obligations become disproportionate. Motivation of rights in the event of a change in the balance between the duties is based on the idea that the nature of a synallagmatic contract lies in a balance between the duties and counter-duties.<sup>\*36</sup> For the sake of that balance, even contractual terms may be modified to ensure the initial proportions.

In German practice, the courts have emphasised the absence of a universal rule for all cases and pointed out that, rather, each case must involve an analysis of how the balance between the parties' duties is influenced by the decrease in the value of money and what the consequences thereof are with regard to the principle of good faith. It has also been found that adjustment of the contract, rather than the right to dissolve the contract, is a reasonable consequence. That position has been motivated on the basis of reference to the general principle that contracts must be performed and the performance is mandatory for the parties and that adjustment of a contract by a court is not an intervention in the freedom of contract but, instead, an act of ensuring a natural consequence to the contract (discharge by performance).<sup>\*37</sup>

In the draft Estonian Law of Obligations Act, the requirement to adjust the contract is also treated as a primary requirement. In accordance with LOA subsection 90 (1), a change in the balance between the contractual duties following the conclusion of the contract is constituted by such change in the circumstances, underlying the conclusion of the contract, that results in a material alteration of the balance between the parties' duties, whereby one party's expenses related to the performance of its duties grow substantially or the value of what is contractually receivable from the other party diminishes substantially. In such event, the aggrieved party may demand, from the other party, adaptation of the contract so as to restore the initial balance between the parties' duties. Thus the Estonian LOA, like PECL article 6:111, is based on the idea that the parties are first bound to enter into negotiations with a view to adapting the contractual terms or terminating the contract. In PECL article 6:111, greater emphasis is laid on the parties' duty to reach agreement by negotiation. The Estonian LOA entitles the aggrieved party to demand, from the other party, adaptation of the contractual terms so as to restore the initial balance between the parties' duties. That statutory right to demand is also realised through the courts' right of gap-filling, because the above-referred provision does not furnish a party with a right to modify the contractual terms. In the event of dispute, the court will decide on such modification of the contractual terms that will best ensure the restoration of the initial balance between the parties' duties and, thus, an equitable division of losses and gains between the parties. If the law contained an obligation to enter into negotiations, as provided in PECL article 6:111, it would also be possible to claim damages from the other party on the basis of violation of the statutory requirement to negotiate. However, the text of the Estonian draft provides for a right to claim instead of obliging the parties to negotiate. Apparently, some consideration should be given to whether the requirement to enter into negotiations would be necessary and whether this would provide parties with better protection if the circumstances relating to the conclusion of the contract have changed and thus, there is a situation in which a claim for performance to the initial extent would be inequitable.

Under the applicable law, a court has no right to modify the terms of a contract if the initial balance has been lost due to a change in the circumstances.

A minimal justification for intervention in the content of a contract is provided by section 64 of the General Part of the Civil Code Act, which lays down the rules for interpretation of transactions. In accordance with subsection 64 (1) of the General Part of the Civil Code Act, the interpretation of a transaction is based on the actual intention of the parties to the transaction unless otherwise provided by the content of the transaction. Hence, the court interpreting a contract may disregard the alleged actual intention of the parties if a different intention is expressed by the objective content of the contract. The accordance of interpretation of contractual terms with the principle of good faith can also be controlled on the basis of subsection 108 (1) of the General Part of the Civil Code Act, which obliges the contracting parties to act in good faith in the exercise of their civil rights and performance of their civil obligations.

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<sup>36</sup> *Ibid.*, p. 523.

<sup>37</sup> *Ibid.*, p. 532.

In German law, the requirement that transactions must be interpreted on the basis of good faith, taking into consideration the general practice, is also contained in *BGB* section 157, which regulates interpretation. In addition, *BGB* section 242 provides for the debtor's obligation to perform its duties in accordance with the principle of good faith, taking into consideration the general practice. Thus, similar results can be achieved in German judicial practice on the basis of either section 157 or section 242. Nevertheless, *BGB* section 242 provides grounds for interpretation with a greater potential for law-creation.<sup>\*38</sup>

Pursuant to LOA subsection 90 (2), modification of contractual terms may be demanded if the aggrieved party did not have reasonable grounds to believe, at the time of concluding the contract, that the circumstances could change and the change in the circumstances was beyond the control of the aggrieved party, and provided that on the basis of law or the contract, the aggrieved party does not bear the risk of a change in the circumstances, and if the aggrieved party had been aware of the change in the circumstances, it would not have concluded the contract or would have concluded the contract on substantially different conditions. Modification of the contract may also be claimed in the event that the circumstances underlying the contract had changed before the conclusion of the contract but the aggrieved party became aware of such change only after entering into the contract. The aggrieved party may also demand modification of the contract with retroactive effect, but not to an earlier date than that of the change in the balance between the duties. In addition to the option of claiming modification of contractual terms, the aggrieved party may also fix an additional period for performance (LOA section 106), withhold performance (LOA sections 102 and 103) or claim damages (LOA section 107). The choice of claims must be based on the fact that courts cannot rewrite contracts. They can only modify the terms insofar as this does not result in an entirely new contract.

If modification of contractual terms is impossible or unreasonable in respect of the other party, the party aggrieved by the change in the circumstances may unilaterally terminate the long-term contract in accordance with the special procedure laid down in section 185. Thus the aggrieved party is provided with an option to unilaterally terminate the contract even without fixing an additional period for performance if the change in the balance between the contractual duties can be demonstrated to serve as grounds for dissolving the contract in accordance with the provisions of law.

Hence the new draft Law of Obligations Act provides several options for withholding performance, either absolutely or for a certain period. How those provisions will be used by persons participating in Estonian economic activities and by judges, *i.e.* the appliers of law, will be seen after the implementation of the Act. The new Act will certainly provide parties in breach with more options to avoid performance of their duties and to postpone the moment of beginning to do what was promised at the time of concluding the contract. Yet there is a danger that courts will come to underestimate the economic practice, the transaction itself and the parties' relations in the transaction. In the case of contracts concluded within the areas of economic and professional activities, there will certainly also be a need to evaluate how the parties have secured themselves against the risks in the contract and which division of risks would be equitable. In any event, the provision of courts with such rights will require the development of certain new techniques in order to reach satisfactory solutions.<sup>\*39</sup>

<sup>38</sup> G. Chievely. *The Future of Common Law. The Wilberforce Lecture, 1997.* – *The International and Comparative Law Quarterly*, 1997, No. 46, p. 752.

<sup>39</sup> L. E. Trakman. *Frustrated Contracts and Legal Fictions.* – *The Modern Law Review*, 1983, No. 46, pp. 39–54.