Legal Remedies Available in Cases Involving Currency Fluctuations: a Comparative Observations From the Laws and Practice of Germany, Russia and the U.S.A.

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Abstract

Currency related risks are the very important consideration for emerging economies. As long as those economies aren't stable enough, contracting parties tend to denominate contract prices in a stable currency, such as US Dollar or Swiss Franc. But in the case of a devaluation of the national currency, performance of the contract may become extremely onerous for the party. One can observe that legal systems of the emerging economies usually aren't prepared for such scenarios and try to deal with those problems on *a casu ad casum* basis.

The thesis compares and analyze solutions to this problem provided by leading Common Law and Civil Law jurisdictions (USA and Germany respectively). Also, thesis will analyze problems emerged in Russia in relation to the economic downturn and solutions proposed by the Russian legal system.

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Introduction

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In the thesis, I would like to compare and analyze solution to this problem provided by leading Common Law and Civil Law jurisdictions (USA and Germany respectively). Also, I would like to look at the problems emerged in Russia in relation to the economic downturn and solutions proposed by the Russian legal system. I chose Russia for two reasons: first of all, Russia is a "home" jurisdiction for me, so it will allow me to examine more documents because there will be no language barrier since I could not say that there is an overabundance of Russian courts' decisions translated into English. Secondly, Russia just experienced currency crisis, so it would be interesting to look how developing legal system addressed this question.

In order to address those issues, in Chapter I I will analyze applicable legal rules and doctrine in each Jurisdiction. In Chapter II I will take a look at how courts of each jurisdiction implement said rules into practice.

Even though topic of this thesis is related to currency fluctuations, I will not refrain myself from analyzing court decisions in relation to similar issues, that affect value of performance. For instance, inflation, which is entirely different thing from depreciation of a currency economically

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speaking, has similar effect for the parties. Performance of one of them became costlier than it was originally agreed or assumed. I hope that reader won't treat such approach as a stretch, but as a possibility to examine more court cases, and thus have better picture of how criteria enshrined in theory and legislation are applied in practice, especially concerning the fact, that economically developed countries usually don't have overabundance of cases pertaining to currency fluctuations.

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Chapter I. Rules applicable to Currency Fluctuations

Section 1. Rules applicable in the Russian Federation.

As in many countries where the currency is volatile, parties in Russia try to resort to something more stable and denominate their obligations in USD or EUR. And there is nothing surprising, that Russian legal order does not restrict parties from doing so.

According to Art. 140 of the Russian civil code, by default, monetary obligations should be denominated in Russian Rubles. Moreover, like other laws of developing nations, Russian Law, essentially do not allow to use any other currency than Ruble in the domestic transactions. At the same time, as basically every other legal order, Russian Law adheres to nominalism principle, which basically means that no matter what happened to the economic circumstances (inflation, fall of exchange rate), an obligor shall pay the same amount as parties agreed on.

Still, the Civil code allow parties to "tie" obligations in rubles to any other currency. In the absence of agreement between the parties, the exchange rate must be official exchange rate on the date when payment is due. And, what is reasonably stems from previous sentence, parties can freely agree on the other applicable exchange rate.

Thus, parties to a contract has two possibilities. First is to denominate monetary obligations in rubles and agree that "nominal" price will change over time because of the inflation, or because of the exchange rate. Second is to state that monetary obligation is defined as such amount of rubles that would be equal to a certain agreed upon sum in foreign currency.

Of course, when exchange rate is stable there is no problem, and parties are happy with their cooperation. But in the time of crisis, when exchange rate goes down, aggrieved party might want to employ certain legal instruments in order to renegotiate the loss, or at least declare contract avoided. And as other legal systems, Russian Law knows at least to ways to tackle this issue: hardship provision (fundamental change of circumstances) and general principle of good faith.

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Subsection 1: Art. 451 – Fundamental Change in Circumstances.

As many others legal orders, Russian Civil Code contains provisions on the hardship. On the one hand, existence of said article makes Russia one of the "open" jurisdictions, where courts are open to change private contracts because of the unexpected change of circumstances and does not exclude change in the exchange rate from the list of such circumstances *a priori*. On the other hand, actual judicial approach to implementation of the hardship provisions places Russia to the list of "closed" jurisdictions, where judicial intervention in the private contractual intervention is borderline impossible. When Russian courts deal with this problem, they usually find any change of exchange rate to be "foreseeable", because currency fluctuations are common in Russia, and every businessperson stumbled upon them at least ones.[1] But the important point here is that for the Russian courts hardship is not a dead man, but more like a person with a missing leg, *i.e.* hardship can be (and is) applied to some other circumstances, but not to cases of currency fluctuations.

In this chapter I will analyze relevant legislation, court practice and relevant doctrine to find out why one could not (at least as of now) rely on the hardship provisions contained in the civil code and what could be done about it.

Setting aside questions of adhesion contracts and consumer protection issues, seems like that in normal B2B relations the most applicable article of the Russian civil code to currency fluctuation issues would be article 451: "Change and Adaptation of a Contract in Connection with a Substantial Change of Circumstances". According to said article, in order for a claim to be successful, the plaintiff must suffice three preconditions: "1) at the time of the conclusion of the contract the parties proceeded on the basis that such a change of circumstances would not occur; 2) the change of circumstances was brought about by causes that the interested party could not overcome after they arose with the degree of care and caution that was demanded of it by the

[1] Anton Ivanov, *Pravovye Problemy Deistviia Valiutnoi Ogovorki v Dogovorakh [Legal Issues of enforceability of the foreign exchange clause],* VESTN. EKON. PRAVOSUD. HER. COMMER. COURTS, 9 (2016).

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nature of the contract and the conditions of commerce; 3) performance of a contract without change of its terms would so disturb the correlation of the contract-related property interests of the parties and would entail such damage for the interested party that it, to a significant degree, would be deprived of that which it had the right to expect upon conclusion of the contract; 4) according to the usages or the essence of the contract the disadvantages party does not bear the risk of change in circumstances"[2].

This provision sounds surprisingly similar to the UNIDROIT Principles of International Contracts (PICC) provisions on the hardship. And this is not a mere coincidence, the influence of art. 6.2.2. of the PICC on the art. 451 of the Russian CC had been confirmed by one of the drafters[3]. And what is even more interesting is the fact the official commentary on the art. 6.2.2. of the PICC lists currency fluctuations as one of the possible factual circumstances where hardship can be applied. Threshold of 80% drop in value of a currency is deemed to be sufficient.[4]

If all elements of the test are present, aggrieved party may ask the court to declare contract avoided. Still, instead of declaring contract avoided, court may adapt the contract. But the court may do so only "in exceptional cases when the rescission of the contract would contradict societal interests or cause damage to the parties, significantly exceeding the expenditures necessary for performance of the contract on the terms changed by the court."[5] This approach is different from the approach undertaken by the drafters of the art. 6.2.3. of the PICC: art. 6.2.3. treat adaptation and avoidance as two equally available options and leave this question for courts' discretion.[6] Also it is worth noting, that other "open" jurisdictions usually floating toward the idea of saving the contract by

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[2] Grazhdanskii Kodeks Rossiiskoi Federatsii [GK RF] [Civil Code]. English Translation of the Part I of the Russian Civil code could be found at https://vk.com/doc6775871_438440255?hash=a8cf1ae31d1f37c147&dl=6e34a18083d58b3c1a

[3] "My zanialis' kodifikatsiei angliiskogo pretsedentnogo prava' // Interv'iu Aleksandra Komarova ["We are codifying English Contract Law" // interview with A. Komarov], ZAKON.RU, https://zakon.ru/discussion/2016/3/22/my_zanyalis_kodifikaciej_anglijskogo_precedentnogo_prava__intervyu_aleksandra_komarova (last visited Feb 16, 2017).

[4] Official commentary on the art. 6.2.2. of the PICC.

[5] Art. 451 (4) GK RF.

[6] Art. 6.2.3. of the PICC.

all means necessary, and using termination or revocation only as a last resort measure.[7] I did not find any explanation on why Russian lawmakers derogated from the general practice. One could speculate, that since most of the time aggrieved party still have interest in the transaction, but just don't quite like the price, such approach would limit amount of persons going into courts, because most of the time court will sever the contract altogether (which is undesirable for the plaintiff).

In order to examine said article, we need to look at all criteria and dismantle and comment on them one by one.

Criterion 1: "at the time of the conclusion of the contract the parties proceeded on the basis that such a change of circumstances would not occur".[8]

First paragraph of the art 451(2) sets the actual unawareness of the parties about the possibility of substantial change in the circumstances as the test to be applied. But as one could see, such approach is deeply problematic, because it is almost impossible to prove what was in the mind of parties at the moment of contract formation if there is no written evidence (letters, pre-contractual negotiation's transcripts, etc.). As a consequence, applying this part of the hardship test, courts interpret the provision in question broader than it actually is, by adding "could not have been aware" as the standard of imputable knowledge.[9]

We could not also overlook sloppy drafting of the "would not occur" part. Of course, since such circumstance occurred, it means that parties knew that currency can theoretically fluctuate. Instead, what drafters supposedly meant is that even though parties knew about theoretical possibility, they did not think that such circumstances would occur during the duration of the contract.

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[7] KONRAD ZWEIGERT & HEIN KÖTZ, INTRODUCTION TO COMPARATIVE LAW 533 (3rd rev. ed ed. 1998).
[8] Art. 451 GK RF.
[9] Konstantin Sklovskii, *Problemy Primeneniia Normy st. 451 GK RF: Valiutnaia Ogovorka i Balans Interesov Storon Dogovora [Problems with implementation of the Art. 451: balance of interests and,* VESTN. EKON. PRAVOSUD. HER. COMMER. COURTS, 2 (2016).

Such obvious mistake led some courts to declare this prerequisite unfulfilled because parties discussed issues pertaining to currency fluctuations during negotiations, or if the contract contained provision stipulating possibility to renegotiate the contract in such cases. Thus, the courts reasoned, parties knew that circumstances may change, and as consequence of this "would not occur" part of the test is unfulfilled.[10]

According to K. Sklovskii, the reasonable interpretation of section in question makes it much close to its source, *i.e.* art. 6.2.2. of the PICC: "the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract". Thus, he argues, art. 451 of the Russian CC shall be read as requiring assumption (not knowledge), according to which, parties, while negotiating and drafting the contract, considered that change of circumstances would not happen, or it would be unsubstantial. Thus, the substantial change of circumstances, he argues, will make contractual terms unfair, and as a consequence of it law must intervene.[11]

Criterion 2: "the change of circumstances was brought about by causes that the interested party could not overcome after they arose with the degree of care and caution that was demanded of it by the nature of the contract and the conditions of commerce".[12]

Second criterion seems to be far less disputed, especially in relation to currency fluctuation. Such circumstances universally deemed to be beyond control of the parties both by doctrine and court practice[13]. Though, one could speculate *arguendo* that big players on the market could influence exchange rate, such allegations are essentially baseless.[14]

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[10] *Id.* at 2.
[11] *Id.* at 5.
[12] Art. 451 (2) GK RF
[13] Ivanov, *supra* note 1 at 4.
[14] Sklovskii, *supra* note 9 at 7.

Criterion 3: "performance of a contract without change of its terms would so disturb the correlation of the contract-related property interests of the parties and would entail such damage for the interested party that it, to a significant degree, would be deprived of that which it had the right to expect upon conclusion of the contract".[15]

This criterion implies that if there is "such damage" for aggrieved party, then there should be corresponding unjust enrichment on the side of the other party. The only reason why we need different norm for currency fluctuation, is the fact, that parties had an actual contract, while unjust enrichment is merely a quasi-contract. [16]

But one may wonder: why profitability will be even considered by law? Rationale behind this intervention is simple. When parties concluded a contract, they perceived its terms as "just" (no matter how objective this perception was). When circumstances change, the consideration that one party will get for performance of the contract will be less than parties initially agreed on, and thus, unjust.[17]

But of course, such reasoning cannot be absolute. Each time courts (let alone government) intervene into contractual relationship, they undermine general principle *pacta sunt servanda.* Some scholars suggest that such interventions shall be kept to a minimum because if one party cannot adapt to the change of circumstances, and thus goes bankrupt, that is merely a normal functioning of a free market economy and competition. Weaker parties will perish and more adaptive and resilient parties will thrive.[18] But as previous criteria provide, such change in circumstances must be outside of party control. Thus, if both parties cannot circumvent the impediment, there is no

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[15] Art. 451 (2) GK RF
[16] Sklovskii, *supra* note 9 at 7.
[17] *Id.* at 7.
[18] Artyom Karapetov, DEVAL'VATSIIA RUBLIA KAK OSNOVANIE DLIA IZMENENIIA DOGOVORA: OPASNYI POVOROT [DEVALVATION AS BASIS FOR CHANGE OF CONTRACT: A DANGEROUS TURN] ZAKON.RU, https://zakon.ru/blog/2016/2/6/devalvaciya_rublya_kak_osnovanie_dlya_izmenenie_dogovora_opasnyj_povorot (last visited Feb 14, 2017).

ground for competition – both parties equally exposed to the undesirable circumstances and it's matter of luck, that one of the parties at gain and other at loss.

As I already stated in the analysis of criterion 1, it does not matter whether partly knew that undesirable circumstances would occur. The only thing that matters is that they deemed that risk of occurrence of such circumstances are minor. Of course, one could object and say that parties could have hedged currency (as well as other) risks. Such objection is indeed valid, but the criterion here is not an actual knowledge, but calculation of the risk. Of course, if risk is major and palpable, there is no need for a court to intervene, because any reasonable person could have and should have seek for insurance. But when Following the same line of reasoning I could argue, *ad absurdum,* that *force major* defense cannot be invoked in case of natural disaster, because everybody knows that mother nature could be rough, and should have built another factory or warehouse somewhere else.

On the other hand, from previous stipulations follows conclusion, that each and every case is unique and when deciding whether change in the exchange constitutes an "unexpected change in circumstance" courts shall thoroughly examine circumstances of the case and determine on what assumptions parties entered into the contract. This is why attempts to define a general percentage failed in almost all jurisdictions.[19] Thus, courts must make a difference between *e.g.* short-term aleatory contracts and long-term lease contracts.

Criterion 4: "according to the usages or the essence of the contract the disadvantaged party does not bear the risk of change in circumstances".[20]

From this criterion follows condition that a contract can be changed or terminated only in case when both parties bears the risks of a change in circumstances. Thus, if we talk about currency

[19] CHRISTOPH BRUNNER, FORCE MAJEURE AND HARDSHIP UNDER GENERAL CONTRACT PRINCIPLES: EXEMPTION FOR NON-PERFORMANCE IN INTERNATIONAL ARBITRATION 425 (2009).
[20] Art. 451 (2) GK RF

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fluctuations the risk is assumed to be borne by only one party – the debtor. But such line of reasoning undertaken by the courts (judicial approach will be discussed in detail in the following chapter), in my opinion, quite far from the truth.

For instance, in lease contracts, lessor will most likely use foreign materials, workforce, know-hows, etc. to repair leased property. Thus, it will be exposed to currency fluctuations in particular and inflation in general. While lease could care less about this risks, because obligations to keep property in good order, as a general rule, assumed by its vis-à-vis.

As we can see from previous example, at least in some types of contracts, both parties are exposed to the currency fluctuations risks. That means, that if one party, namely lease assumes all currency risks because of denomination of the contract in foreign currency, that makes contract unbalanced.[21] Of course unbalance of a contract per se cannot be sufficient ground for court's intervention. But criteria provided in art. 451 suggests that such intervention could be exercised in extreme situations, where such unfairness of the contract became unbearable for one of the parties, while by default should be dire for both of them.

Subsectioin 2: art. 10 – principle of good faith.

Careful reader might ask, why there is a need to make a section about general principle of law, if we already discussed lex specialis. Answer to this question is not a doctrinal, but practical one. As I stated above, Russian courts don't particularly like to apply art. 451 to cases of currency fluctuations. And this approach has been championed by Supreme Commercial Court of Russian Federation. Thus, if lower court sees that it would be unreasonable and unfair to hold aggrieved party to a contract, it has to find something else in the Civil Code to base its decision on. Usually, when courts try to avoid using art. 451, they resort to principle of good faith as a last resort.

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[21] Sklovskii, *supra* note 9 at 10.

Without going into great detail into reasoning of courts (which will be done in chapter 2), I want to underline whether or not good faith can be applied to cases of currency fluctuations from a theoretical point of view.

As a consequence of acting in a bad faith, art. 10 of Russian Civil Code allows tribunals to "fully or partially deny the person protection of the right belonging to him and may also take other measures provided by statute"[22]. So, from the point of view of the black-letter law, courts have the power to completely deny ordering debtor to pay outstanding price, or to reduce outstanding price to what courts deems to be fair. The latter seems to be more appropriate in the case of currency fluctuations, and I cannot find any example of courts taking first road (except for the cases when debtor already payed according to "right" exchange rate and creditor were seeking presumably outstanding purchase price).

Why parties resort to denominating their obligations in some currency which is more stable than ruble? The main rationale behind it usually would be to fix monetary consideration to some amount of money denominated in a stable currency or in other words to hedge risks.[23] And of course, *per se* such measures are reasonable and in compliance with bona fides.[24] But on the other hand it is obvious that goal of fixing monetary consideration cannot be achieved in case of rampant fluctuation of the exchange rate. But, in almost every case, parties do not contractually limit fluctuations to a certain limit, and allow currency to fluctuate as much as possible.[25] Seems like, for courts the only way to keep denomination clause to its actual purpose is to apply art. 10, because, as they think, asking more than initially was assumed to be fair by both parties goes against principle of good will.

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[22] Art. 10 (2) GK RF
[23] L. A. LUNTS, DEN'GI I DENEZHNYE OBIAZATEL'STVA V GRAZHDANSKOM PRAVE 222 (2004).
[24] V.F JAKOVLEV, KOMMENTARIJ SUDEBNO-ARBITRAŽNOJ PRAKTIKI 15 (2007).
[25] S. D. RADCHENKO, ZLOUPOTREBLENIE PRAVOM V GRAZHDANSKOM PRAVE ROSSII 200 (2010).

As we can see, even though there is no reason to apply good faith principle in relation to currency fluctuations, because of existence of article 451. Still, we'll see on German example, that general principle of good faith is used as a make-shift for actual hardship provision not only in the Russian Federation.

Section 2. Rules applicable in Germany.

Before consequences of the First World War had hit German economy, German courts and legislators thought about hardship as of something unnecessary, something that goes against cornerstone principle of *patca sunt servanda.*[26] Hardship-like provision related to Windscheid's theory of assumption (Voraussetzung) was heavenly criticized during legislative process, and was abolished in the second draft of the BGB.[27] But devastating financial crisis quickly changed position of courts, and they started to apply hardship to change pre-war contracts using Oertmann's theory of change in the basis of the transaction (Geschaftsgrundlage). Much later, judicial approach was incorporated into the BGB under §313.

The first serious theoretical justification for application of hardship defense was Windscheid's theory of assumption. According to this theory, assumption is nothing more than "inchoate condition"[28]. That means "that legal consequence should only occur under certain circumstances"[29]. Thus, using this theory, per Windscheid, courts may conclude, that an agreement was concluded under assumption that "state of affairs will remain the same"[30]. If the circumstances will change, parties will have a right to rescind the contract.

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[26] Artem Sirota & Ekaterina Ivanova, *Deval'vatsiia rublia i valiutnaia arenda. Argumenty za i protiv primeneniia stat'i 451 GK RF v usloviiakh krizisa [Devalvation and lease contracts. Pro and contra application of the art. 451 of the Russian Civil Code]*, 26 ARBITR. PRAKT. ARBITR. PRACT., 2 (2016).
[27] Alexander Zeits, *Vliianie izmenivshikhsia obstoiatel'stv na silu dogovorov (clausula rebus sic stantibus) [Change of circumstances and its effect on enforceability of contracts (clausula rebus sic stantibus)]*, VESTN. GRAZHDANSKOGO PRAVA PRIV. LAW HER. 207–262, 230 (2013).
[28] ZWEIGERT AND KÖTZ, *supra* note 7 at 519.
[29] *Id.* at 519.
[30] *Id.* at 519.

Critics of this theory (esp. Lenel) pointed out that the theory do not provide any ground which would help to distinguish condition and motive. Lack of such distinction can seriously hamper stability of legal framework, since motive stands beyond agreement between parties, and thus cannot affect the contract .[31] This theory was described as "psychological", because it pertains to actual thoughts the party at the time of conclusion and do not take into account whether other party knew or at least was aware of such thoughts.[32] Perhaps, modern lawyers may call such thing a "mental reservation", which is non-relevant for a contract formation and performance in may legal systems. Because of this criticism, theory of assumption was rejected during drafting process of the BGB.

But what seemed to be a reasonable decision in a stable economic conditions, quickly become a nonsense when the Great War broke in the year of 1914. At first German courts either deemed supervening events to be impossibility in the sense of §275 of the BGB.[33] Zweigert and Kotz distinguish between two groups of cases. In the first group of cases, courts deemed that performance after change in the circumstances occurred would be entirely different from what was originally promised in the contract.[34] In the second group of decisions, courts discharged suppliers from their obligations, reasoning that in the changed circumstances, demanding delivery would be too much to ask from the producer.[35]

But those decisions lacked any theoretical explanation, which was finally presented by Oertmann in year of 1921. Oertmann introduced term "basis of the transaction" (Geschaftsgrundlage). Under this term he understood "assumptions that were in place at the date of contract formation and existence of which are not disputed by contracting parties, and existence or happening of which

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[31] Zeits, *supra* note 27 at 252.
[32] ZWEIGERT AND KÖTZ, *supra* note 7 at 522.
[33] *Id.* at 520.
[34] *Id.* at 520.
[35] *Id.* at 520.

served as a basis of the transaction"[36]. Since change in circumstances eliminates assumptions made by the parties at the time of contracting, basis of the transaction will be also eliminated, which, per Oertermann, should give parties the right to rescind the contract. Why? Because, as Oertemann stated, "in situation of crisis and reevaluation of economical and political values, demand to performance of the contract will lead to breach of principle of good faith (Treu und Glauben), because such performance may lead to insolvency of the debtor"[37].

But, Oertemann theory also has its shortcomings. As noted by Zweiger and Kotz, the most problematic of them, is that this doctrine does not encompass change of circumstances that were not or could not be reasonably foreseen by the parties. Since parties did not foresee circumstances, they could not make or express any assumption about their existence.[38] Nevertheless, courts simply disregarded this problem, and continually used this theory and used theory to "dress up purely material considerations"[39].

Nowadays in doctrine, German lawyers make a distinction between small basis of the transaction and big basis of the transaction. By small basis of the transaction German doctrine understands circumstances that pertain to one of the parties. For instance: inability to obtain permit to construct a building.[40] On the other hand, circumstances that affect a vast number of person, such as wars, revolutions, economic crisis form big basis of transaction.[41] Worth noting that in one of the cases court treated reunification of Germany as an event, that parties thought won't happen, and thus, adapted the contract.[42]

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[36] PAUL OERTMANN, DIE GESCHÄFTSGRUNDLAGE: EIN NEUER RECHTSBEGRIFF (1921). *Translated by author from Russian translation.*
[37] *Id.*
[38] ZWEIGERT AND KÖTZ, *supra* note 7 at 522.
[39] *Id.* at 522.
[40] Sirota and Ivanova, *supra* note 26 at 30.
[41] *Id.* at 30.
[42] BGH, 21.09.1995 - VII ZR 80/94

Important distinction must be made between approach undertaken by Russian legislator and German doctrine, and, later, by section 313 of the BGB. Russian Civil Code as a desirable remedy in case of substantial change in the circumstances is rescission of the agreement. Courts may change the agreement only in exceptional cases when "the rescission of the contract would contradict societal interests or cause damage to the parties, significantly exceeding the expenditures necessary for performance of the contract".[43] On the other hand, German courts and BGB firmly follow principle of *favor contractus* and, thus, on the contrary, allow rescission only in cases when "adaptation of the contract is not possible or one party cannot reasonably be expected to accept it".[44]

However, on a practical level, as it will be shown in the following chapter, Russian courts displayed no reluctance to apply such exception. So to say, courts generally do not even bother explaining what "societal interests" or "damage to the parties" are present.[45]

That means that in fact, art. 451 of the Russian Civil code provide more options for the parties, but unlike §313 of the BGB is not applicable to cases of currency fluctuations.

Section 3. Rules applicable in the United States of America.

United States' law, being common law system question regarding right to rescind the contract is governed both by norm of common law and statutory law. With regard to the common law, here, as in English law one can observe existence of doctrine "frustration of purpose" in the US law. With regard to the latter, UCC encompasses two doctrines, impossibility and impracticability. Even though those two doctrines are interpreted and applied separately, some American lawyers say that they are pretty much "different variations of the same idea".[46] Statutory provisions have some

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[43] Art. 451(4) GK RF
[44] §313(3) BGB
[45] Ilya Kokorin & Jeroen Van der Weide, *Force Majeure and Unforeseen Change of Circumstances. The Case of Embargoes and Currency Fluctuations (Russian, German and French Approaches)*, 3 RUSS. LAW J. 46–82 (2015).
[46] EWAN MCKENDRICK, FORCE MAJEURE AND FRUSTRATION OF CONTRACT 320 (2013), http://books.google.com/books?hl=en&lr=&id=o0hWAgAAQBAJ&oi=fnd&pg=PP1&dq=%22set+in+10/12pt+Times%22+%22there+will+be+changes+in+circumstances+ranging+from+the+minor+to+the%22+%22for+its+ap

peculiar aspects that distinct them from classical common law doctrine of frustration. Such differences, as it will be shown in the next chapter, may seriously affect reasoning of the courts.

To better illustrate difference between theories I will illustrate them with examples.

Let's assume that foreign company concluded with an US company a contract to supply oil from Middle Eastern country X to the US.

In case when authorities of country X forbade any oil export from the country X. In such event, seller may use impossibility defense as long as unexpected actions of the government authorities made contract impossible to perform.

In case when for some reason, it became impossible for the buyer to profitably resell oil in the US (e.g. consumers boycotted all goods from country X, or suddenly changed all Hummers for Teslas). Since, purpose of the contract for the buyer was to resell oil in the US, and such goal cannot be reasonably achieved, buyer may invoke frustration of purpose and rescind the contract, since circumstances, which were not foreseeable at the time of contract formation, lead to non-existence of the purpose of the contract.

Let's assume that our contract was denominated in dollars, but seller purchase oil from its suppliers in currency of country X. During performance of the contract, currency of country X became substantially stronger and now values two times more than at the time of contract formation. Since price were denominated in dollars, and seller pay for the good in country X currency, on each transaction he is getting payed 2 times less than parties agreed upon. In such circumstances, we have a case of impracticability – it is still possible to fulfill one's obligations, but such contract is overly burdensome, and commercially unreasonable for a party.

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plication.+This+is+graphically+illustrated+by+the+first+of+Mr%22+&ots=BtjVUrHjA9&sig=uCSQ6SQ0-jkPPbp59VH3tm0QGAU (last visited Dec 12, 2016).

In order to invoke those defaces, parties shall be unaware about such supervening events at the time of contract formation.

Now, let's move to provisions of article 2 of the Uniform Commercial Code. Those provisions were formed on the basis of three doctrines, that I just illustrated.

Section 2-613 of the UCC pertains only to cases when unique, irreplaceable chattel were destroyed without culpa of one of the parties. That means, that this section cannot be invoked in cases of currency fluctuations.

Section 2-614 is concerned with slightly different issues. It regulates cases when methods of performance of contractual obligations, initially agreed between parties changed, namely method of payment or method of delivery. In this case, contract will not be rescinded, instead, party is obliged to provide a "commercially reasonable" substitute. Worth noting, that party may propose "commercially reasonable" substitute only in case when agreed method of performance became commercially impracticable.

Section 2-615 of the UCC seems to be the most appropriate rule to the cases of currency fluctuations. Even though, said sections talks only about breach of contract by the buyer, some commentators, using official commentary and general applicability of Restatement second on contracts as a gap-filler, deem this section to be applicable to both parties in the contract.[47] Said section allow seller (and, if one side with prof. Jenkins, buyer) to avoid liability for the breach of contract because contract became "impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made".[48]

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[47] Sarah Howard Jenkins, *Exemption for Nonperformance: UCC, CISG, UNIDROIT Principles–A Comparative Assessment*, 72 TUL REV 2015, 2024 (1997).
[48] Sec. 2-615 UCC

Perhaps one of the most discussed issues concerning application of section 2-615 is application of this section to cases of increase in expenses, prices and currency fluctuations.

Usually, courts are quite reluctant to apply section 2-615 to such cases because in order to avoid liability, contracting party must prove evidences that would suffice 3 requisites of section 2-615.

First requirement concern risk sharing. Party that is trying to avoid the contract shall not assume the risk in the contract. For example, if party expressed its concern about fluctuation of foreign currency, but did nothing to hedge them, deemed to be assumed the risk.[49]

Second requirement is that event (or contingency, in the UCC terminology) shall make contract commercially impracticable. That means that regular inflation, or seasonal changes in market conditions cannot be sufficient. In this criterion we talk about change so drastic, that performance of the contract shall become essentially prohibitive.

Third criterion is connected to the second one. According to it, commercial impracticability must be the result of "the occurrence of a contingence the non - occurrence of which was a basic assumption on which the contract was made".[50]

As one can see, criteria provided in Article 2 of the UCC resembles criteria discussed in previous chapters in relation to Russian and German laws.

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[49] Bernina Distributors, Inc., Plaintiff-appellee, v. Bernina Sewing Machine Co., Inc., Defendant-appellant, 646 F.2d 434 (10th Cir. 1981)
[50] Sec. 2-615 UCC

Chapter II. Application of rules by the courts.

Section 1. Application of the rules in Russia.

As I stated earlier: even though legislation-wise Russian Federation is an open jurisdiction, the courts' practice continually declines to recognize change in the exchange rate as a circumstance that will trigger art. 451. During most recent financial crises (1998 and 2008), the Supreme Court of Arbitration repeatedly stated that "Even if devaluation or inflation substantially deflect the price from the price on the market, it is still not a substantial change of circumstances, because reasonable business person is aware that Russian currency is potentially unstable".[51] Though, during both crises one could find some anecdotal examples when the hardship claim was successful, they do not skew the main trend, and, as some lawyers speculate, were caused by corruption or inducement from the government.[52]

On the highest level of judiciary, the practice was clear: inflation or devaluation is not a substantial change of circumstances.[53] Worth noting that position of courts did not change even in case when actual payment (denominated in USD) were much higher than medium price on the market (denominated in RUB).[54]

And even though the current financial crisis is far more dire than one encountered in 2008[55], practice of the Russian courts did not change their opinion (at least on the higher level).[56] Courts are still reluctant to apply hardship provisions in cases of purely financial difficulties on the side of one of the parties. Though it would be wrong to say that hardship in Russia is dead in buried. Courts apply art. 451 in cases when not only general dire financial conditions are present, but also

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[51] Sirota and Ivanova, *supra* note 26 at 33.
[52] Karapetov, *supra* note 18.
[53] Postanovlenie Prezidiuma VAS RF 30.11.2010 № A17-1960/2009 [Decision of the Supreme Commercial court]
[54] Postanovlenie Prezidiuma VAS RF 10.05.2012 № A11-847/2009 [Decision of the Supreme Commercial court]
[55] Russian financial crisis (2014–present), WIKIPEDIA (2017), https://en.wikipedia.org/w/index.php?title=Russian_financial_crisis_(2014%E2%80%93present)&oldid=771946824 (last visited Mar 31, 2017).
[56] Sirota and Ivanova, *supra* note 26 at 33.

some personal misfortunes of the obligee. For instance, in the cases, when there were clear evidences of undue coercion. If obligor insisted on including fixed exchange clause using his dominant position, even though it was obvious that crisis is present and rampant, obligee may rely on hardship defense (please note that this case were decided by lower court and were not tried in the upper courts).[57] One other example, is decision that were upheld by district court, in which court allowed lessee to rescind the contract because his underage son were diagnosed with cancer.[58]

Generally speaking, courts find art. 451 to be applicable in cases of legal impossibility, not hardship. For instance, courts allow lease contract to be rescinded with refer to art. 451 when leased property were arrested or forfeitured.[59] Moreover, courts find art. 451 to be applicable to the cases of frustration of purpose. E.g. if it is impossible to obtain a permit to construct a building on a leased piece of land.[60] Or in case if construction works were prohibited by the government after the permit were obtained.[61]

As one can see, in applying criteria mentioned in art. 451, courts are overly prohibitive, and boil down hardship provision to frustration of purpose provision.

I will mirror structure established in section 1 subsection 1 of the chapter I and present how courts interpret each criterion provided in art 451.

Criterion 1: "at the time of the conclusion of the contract the parties proceeded on the basis that such a change of circumstances would not occur".[62]

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[57] Postanovlenie AS Povolzhskogo okruga 27.10.2014 № A12-1193/2014 [Decision of Commercial Court of appeal in Privolzhye]
[58] Postanovlenie AS Moskovskogo okruga 04.03.2015 по делу № A40-28345/14 [Decision of Commercial Court of appeal in Moscow region]
[59] Postanovlenie Prezidiuma VAS RF 08.06.2015 № A32-30786/2013 [Decision of the Supreme Commercial court]
[60] Postanovlenie Prezidiuma VAS RF 03.03.2016 № A40-129910/2014 [Decision of the Supreme Commercial court]
[61] Postanovlenie Prezidiuma VAS RF 02.11.2015 № A32-28623/2014 [Decision of the Supreme Commercial court]
[62] Art. 451 GK RF.

First and foremost, courts declare art. 451 inapplicable because this "hypothetical criteria" is lacking.[63] Courts reason that because for the last 20 years Russia already encountered financial crisis more than once, any party could foresaw such undesirable event. Russian lawyer A. Sirota thinks that root from such thinking follows from human psychology, and not from a bad faith on the side of the court. He reasons that when a bystander tries to analyze reasoning of the parties retrospectively, he would usually overestimate their cognitive and prognostic abilities.[64] Indeed it is very easy to say something was obvious when you know the outcome. Besides, not all crises created equal. And it would be correct to say, that for a parties unforeseeable is not the mere fact of occurrence of a drop in exchange rate, but a level of such drop.

In order to minimize currency risks and to make contractual relationship more predictable would include adaptation clause in the contract. A typical clause would include obligation to begin negotiations in a good faith if inflation or change in the exchange rate will hit some predetermined level.[65] But instead of helping aggrieved party, such clause is typically interpreted as acknowledgement by the parties the possibility that an undesirable event would happen and thus, assumed all risks pertaining to this event.[66] In one decision, Moscow commercial court deemed art. 451 inapplicable since parties included adaptation clause which stipulated 3% change in exchange rate as a prerequisite for renegotiations (actual change in exchange rate was around 22-25%).[67] Even though I agree with the outcome of the decision, since 25% fluctuation is not enough to invoke hardship by any standard[68], this line of reasoning is flawed and sloppy. As I said earlier, nobody could say that fluctuations were not predicted by the parties, the level of fluctuations were

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[63] Sirota and Ivanova, *supra* note 26 at 34.
[64] *Id.* at 34.
[65] *Id.* at 35.
[66] Postanovlenie AS Povolzhskogo okruga 29.06.2015 № A57-15264/2014 [Decision of Commercial Court of appeal in Privolzhye]
[67] Postanovlenie AS Moskovskogo okruga 06.11.2015 № A40-67481/2015 [Decision of Commercial Court of appeal in Moscow region]
[68] For comparison between different thresholds see: BRUNNER, *supra* note 19.

unpredicted by the parties. That's why courts discriminate between predictability of an event and predictability of the effect this event would have on the contractual relationship.

Criterion 2: "the change of circumstances was brought about by causes that the interested party could not overcome after they arose with the degree of care and caution that was demanded of it by the nature of the contract and the conditions of commerce".[69]

As I previously mentioned, there is essentially no discussion on this criterion on the theoretical level. But courts seem to imagine parties as being some sort of ubermenschen that could overcome everything. For instance, a bank loan from Russian bank was denominated in dollars. Obligee, who was close to insolvency because of currency fluctuations, tried to invoke art. 451. Court denied this request, reasoning that obligee could have predicted that ruble will fall even further and refinance loan denominated in dollars using loans denominated in rubles.[70] But such arguments can hardly be accepted. The goal of hardship provision is to restore contractual balance of parties, and not to make obligee a slave, but to a different master.

Criterion 3: "performance of a contract without change of its terms would so disturb the correlation of the contract-related property interests of the parties and would entail such damage for the interested party that it, to a significant degree, would be deprived of that which it had the right to expect upon conclusion of the contract".[71]

Third criterion seems to be the most important one, because the goal of art. 451 is to correct contractual imbalance, or at least sever contractual relationship that became unreasonably burdensome for one of the parties. But such analysis can be rarely stumbled upon in Russian court

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[69] Art. 451 (2) GK RF
[70] Postanovlenie AS Moskovskogo okruga 11.02.2015 № A40-21817/13-156-204 [Decision of Commercial Court of appeal in Moscow region]
[71] Art. 451 (2) GK RF

decisions. Since lack of one criterion is already enough to deny application of art. 451, so courts usually take easy route and make predictability argument (which, as I stated above, is flawed).

Criterion 4: "according to the usages or the essence of the contract the disadvantaged party does not bear the risk of change in circumstances".[72]

Perhaps the simplest (and, thus, most popular) way to dismiss hardship claim is to make a reference to art. 140 of the Russian Civil code which states that "the ruble is the legal means of payment obligatory for acceptance at face value on the whole territory of the Russian Federation"[73]. Thus, if parties decided to "betray" ruble and resort to some other currency, parties automatically assumed all follow-up risks.[74]

Let's dissect this argument. It is indeed true that debtor bears the risk of change in the value of his consideration. But if the inflation or devaluation were so rampant that both parties cannot predict it, it would be unreasonable and unfair to place the burden only on one of them. At the same time, as I stated in the analysis in chapter I, we could imagine, that sometimes both parties are at risk. For example, if one party undertakes to sell some expensive foreign-made machinery, it would be reasonable for such party to denominate price in currency of producer's place of business. Thus, if the court would lower the purchase price, the seller would be in a serious loss, because he would pay his supplier in currency other than ruble. That means that hardship is not a one-size-fits-all solution, but an instrument that should applied after serious reasoning and consideration.

As one can see, application of art. 451 is impossible in cases of currency fluctuations. But courts can deny application of hardship provision, but they cannot ben objective reality, which created the problem of impracticability of performance. That's why some lower courts formally stating that there is no ground for application of the art. 451, they still adapt contracts using art 10

[72] Art. 451 (2) GK RF
[73] Art. 140 GK RF
[74] Postanovlenie Dvenadtsatogo arbitrazhnogo apelliatsionnogo suda ot 05.06.2015 po delu № A06-9802/2014 [Decision of the Twelve Circuit Court of Cassation].

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(prohibition to act in bad faith) as a disguise. Even though German courts also used Treu und Glauben, theu did it before section 313 were enacted. And situation when courts apply *lex generalis* to situations where *lex specialis* ought to be applied is unconscionable and goes against any line of legal reasoning.

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Section 2. Application of the rules in Germany.

I must note, that vast majority of cases concerned inflation. Though, this shall not be regarded as being indication that this practice cannot be applied by analogy to currency fluctuations. In fact, currency fluctuations and inflation lead to the same result: party has to pay more, or receive more than it was previously agreed,

At first, German courts were cautious to regard change in circumstances as basis for a decision to change the contract. For instance, in the year of 1915, Reichsgericht refused to rescind lease contract because of the war, since possibility to rescind a contract on this ground as it nowhere to be found in the BGB.[75]

However, when war has ended, the economic crisis only began. Facing such circumstances, courts were quick to abandon such formalistic approach. Worth noting that Reichsgericht's practice started to change in years of 1920-1921, when inflation become galloping. In year of 1922 inflation became astronomical, topping at trillion percent points.

As early as in June of 1920, Reichsgerich, even though declining to rescind the lease contract, pointed out that it is hypothetically possible to change the contract if dire and unexpected change in the value of performance may resolve in insolvency of a contracting party.[76] As a justification of such change, the court made a reference to the §242 of the BGB (principle of good faith).

In September of 1920, basing its decision on the §242 of the BGB, Reichsgerich overruled decisions of the lower courts, which declined to change price in the lease agreement. The interesting part of this agreement was that lessor, were also supplying heat to the lessee. Because heat prices went up 10 times, lessor sought to change the contract. Reichsgerich remanded the case stating that in the situation when both parties want to save their contractual relationship, but

[75] RGZ 86, 397
[76] RGZ 99, 259

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circumstances changed in an unexpected way, it would be unreasonable for only one party to bear all negative consequences of such change.[77]

In November 1921, following same reasoning, Reichsgerich declined enforcement of sale contract. Court noted, that in synallagmatic contracts parties as a rule wants to reach just agreement. And if because of supervening events value of one party's consideration changes so substantially, that it becomes not even roughly an equivalent of other party's performance, that debtee, asking court for the enforcement of such contract breaches principle of good faith.[78]

As I stated in the previous chapter, around this time, German jurist Oertmann introduced theory of change in the basis of the transaction. This theory, unlike Windscheid's idea of assumption, were quickly picked up by courts and even directly referred to. As early as in February 1922, Reichsgerich directly cited said theory in Textile plant case, which can be deemed as official acknowledgement of existence of doctrine of substantial change in circumstances in German law.[79] In the said case, one of the shareholders of the company that owned textile factory, decided to sell factory building and land. Contract was successfully concluded in May of 1919, a couple of months before first huge inflation increase. In the same time, seller received first payment. But when second payment was due, Mark devaluated so drastically, that nominalistic approach would inevitably disrupt contractual balance.[80]

In the same year, Reichsgerich decided on a case concerning not inflation, but currency fluctuations. Parties concluded contract for lease of agricultural land for the period of 15 years.

Payments for the lease were tied to gold equivalent.[81] On September 28 1914, according to Bundesrat decree, all contracts denominated in gold were announced to be unenforceable until

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[77] RGZ 100, 130
[78] RGZ 103, 177
[79] Sirota and Ivanova, *supra* note 26 at 30.
[80] RGZ 103, 328
[81] RG 104, 218.

special order. Lessee filed a motion, asked court to allow him to pay in paper Marks. Lessor, protested, stating that performance of the contract according to nominal price, would be extremely unfavorable for him because of the inflation, and would barely cover property taxes and other expenses. On the other hand, because of the inflation and general food shortage, profits of the lessee substantially increased. In such situation, Reichsgerich remanded case to lower courts, instructing them to determine fair price of the lease by finding the balance between lessor's increased expenses and lessee's increased profits.

Worth noting, that courts at some point of time opened flood gate, and started to adapt contracts, which needed no adaptation. In one of the cases, court held that even 13% devaluation is enough for basis of the transaction to disappear.[82]

However, such practice stayed in post IWW era. Nowadays, German judicial practice makes clear distinction between unexpected change in circumstances and expected, even though substantial in comparison with the time of contracting. With this regard, interesting case was decided in 1978 by Bundesgerichtshof. In this case, company, operating a Hotel, tried to lower lease payments in long-term contract, because market structure substantially changed, and thus, new costly investments are to be made to ensure profitability of the Hotel. Court dismissed the claim, because lessee should bear risk of normal change in the market conditions.[83]

In a similar case, Bundesgerichtshof stated that even though over period of sixty ears, lease payment dropped down around 70% from original value because of inflation, such risk is to be borne by lessor, since such gradual decrease in value is normal and could be expected by any reasonable person. If parties wanted to hedge such risk, they could easily include adaptation clause in the contract, since they concluded contract for such a long period of time.[84]

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[82] Kokorin and Van der Weide, *supra* note 45 at 65.
[83] NJW 1978, 2390
[84] NJW 1959, 2203

Section 3. Application of the rules in the United States of America.

As I stated in the previous chapter, American courts treat application of section 2-615 with some degree of suspiciousness and quite rarely find said section to be applicable at all, let alone to cases of currency fluctuations and change in market conditions.

As in the Russian Federation, the most problematic requirement is unawareness about the risk. The US courts generally in line with their Russian counterparts, stating that since party acknowledged risk, it could not be exempted from performance. Some commentators find this approach overly restrictive, since section 2-615 says only about assumption that undesirable effect will not happen.[85] That means that according to the statute it does not matter whether party knew about the possibility that undesirable event can potentially occur. It matters whether parties mutually assumed that it will not occur.

For instance, in *Bernina Distrbutors, Inc. v. Bemina Sewing Machine Co,* court find sec. 2-615 to be inapplicable to the dispute precisely because of that. In this case, importer of sewing machines and distributor entered into a contract for sale of such machines. There was no fixed cost per machine in the contract, instead, importer would convert price in Swiss francs into US dollars. Two years after contract was concluded, fluctuation of the exchange rate doubled costs of the importer by 100%. Tenth Circuit based its decision on the two main things. First of all, court argued that since importer agreed to have fixed gross profit, it assumed that with devaluation of the dollar its profits also will go down.[86] Moreover, court found that letter, where importer expressed concerns over exchange rate, to be a sign of knowledge of the importer about the risk. It's worth noting though, that importer was concerned about increase in merely 7%.[87] As I already stated in Section 1 of Chapter I, there is crucial difference between increase in 7% and 100%. Indeed, both of them are

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[85] Laura Stevenson Conrad, *Bernina Distributors, Inc. v. Bernina Sewing Machine Co.: New Grounds for Commercial Impracticability Based on Currency Exchange Rates under Uniform Commercial Code Secion 2-615*, 8 NCJ INTL COM REG 117 (182).
[86] *Id.* at 120.
[87] Bernina Distributors, Inc., Plaintiff-appellee, v. Bernina Sewing Machine Co., Inc., Defendant-appellant, 646 F.2d 434 (10th Cir. 1981)

caused by the same economical process, but parties, when making evaluation of the contract may find 7% to be acceptable level. That means that knowledge bout fact that currencies fluctuate, cannot, in principle preclude parties to resort to hardship (or impracticability) defense.

However, US courts did much better job in analyzing how adverse circumstances affect both parties. In Eastern Air Lines v Gulf Oil Corp, parties concluded contract for sale of crude oil. Because of crisis on the crude oil market and drastic increase in prices, defendant asked court to apply section 2-615 of the UCC. Court stated that during financial crisis, Gulf Oil actually increased its profits, thus there was no adverse effect for defendant. We could easily agree with this position. But, in the second part of decision, court restated well-known mantra about knowledge requirement. Since everybody at that point in time (year of 1973) knew about the fact that situation in the Middle East is shaky, parties could foresee such impediments.[88] I want to emphasize this point again: parties could predict inflation, devaluations, and price increases. However, they are not in position to predict occurrence of circumstances that are beyond normal market fluctuations.

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[88] Eastern Air Lines, Inc. v. Gulf Oil Corp., 415 F. Supp. 429 (S.D. Fla. 1975)

Conclusion

Perhaps the most shocking revelation for the author was the fact, that in all three jurisdictions rules, that can be applied to the cases of currency fluctuations are more or less the same. Of course, there are differences in the legal consequences of their application, but the criteria for their application are essentially the same.

But why then application of mostly the same rules was different? My best guess would be that all possible factors would have nothing to do with the law. Even though we could speculate that/ perhaps, in Russia courts are not fully independent, I wouldn't explain why we see on the level of lower courts, some decisions that adapt contracts to changed circumstances. If it were for abuse of power, then decisions on the lower level would never exist.

Finding out that in the US courts have the same problems with application of hardship, I found a better explanation. In none of the countries: nor the US nor Russia, for the past history, did not experience financial crisis as dire as in Germany. Perhaps, entire world shall start to fall apart, so courts can see that blind adherence to principle of *pacta sunt servada* at any cost can lead to disastrous consequences.

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