MOROĞLU ARSEVEN

Governing Law: A Game Changer in Energy Price-Review Disputes

6 Dec 2022

The energy sector has been struggling with an unprecedented crisis generated by a combination of many factors, including fallouts of the COVID-19 pandemic and consequential supply-chain disruptions, global responses and opposing measures based upon the Ukraine-Russia conflict, State interventions, and compliance pursuit of decarbonization policies. As the world faces record-level increases in energy prices, disputes and hardships observed in the performance of the energy trading contracts concluded prior to or during the rise of the crisis have been scaling up.

Facing such unavertable challenges, adopting extensive price review and adjustment clauses in contracts has emerged as a primary solution in order to protect each party from crushing outcomes in the event of a devastating change in circumstances, including any measures which may be imposed by governments, as well as price fluctuations in the market. Given that the parties stipulate a framework for a remedy -foreseeing a situation in which one of the parties has difficulty with the performance of their obligations under the contract-, a probable dispute may be prevented or become easier to arbitrate, in accordance with the parties' prior intentions. However, in most cases, contractual remedies may be either inexistent or inefficient. Under these circumstances, the law governing the energy trading contracts comes into prominence and remedies offered thereunder tip the balance in price-review disputes.

While each legal system comes with its own pros and cons depending on the particularities of individual contracts, choosing between Civil Law and Common Law with their distinctive features is the first fork in the decision-making process. We take a brief look below at how the remedies may differ from one to another law tradition in response to fundamental price changes.

Civil Law Perspective: Hardship or Extreme Difficulty in Performance

Clausula rebus sic stantibus doctrine, which constitutes an exception to the *pacta sunt servanda* rule, principally provides that a party's obligations under a contract may be deemed unperformable if a fundamental change occurs in the factors affecting such performance. The doctrine appears as hardship or extreme difficulty in performance in Civil Law systems.

The main common ground shared by Civil Law systems in terms of hardship is the possibility to adapt and/or renegotiate the contract as opposed to terminating it altogether. Accordingly, under most Civil Law systems, in the event that an extraordinary circumstance such as extreme price inflation occurs:

- which was not or could not have been expected to be foreseen by the parties at the time of the conclusion of the contract;
- as a result of a reason not caused by the debtor, and
- the circumstances present at the time of the contract fundamentally changed against the debtor in a manner that requiring performance would be in contradiction with the good faith principle;

then the debtor may ask to adapt or renegotiate the contract, or terminate it if adaptating it is not possible.

This remedy is forthrightly codified in legislation under some legal systems such as Turkish law (*Article 138 of Turkish Code of Obligations*), German law (*Article 313 of the German Civil Code*), and French Law (*Article 1195 of the French Civil Code*). There are also certain legal systems, such as Swiss law, that apply the doctrine through the duty of good faith.

Through renegotiation or adaptation, the price agreed upon in energy trading contracts may be adjusted, or a price review mechanism may be implemented in a manner that would allow the continuation of the long-term performance for both parties in accordance with the good faith principle. This opportunity requires the assessment of the conditions surrounding each case on a case-by-case basis. Similarly to how the issue is handled in Civil Law systems, it is notable that adaptation is not easily implemented by arbitral tribunals or courts: parties are now expected to be more prepared for market fluctuations which have become the new normal. For example, the Turkish Court of Cassation has stated, in many decisions, that even if the hyperinflation is of great severity, such economic change in circumstances would not solely justify the adaptation of contracts since hyperinflation is not an unprecedented phenomenon for the Turkish economy. However, there are also decisions of the Court of Cassation stating that, whether the conditions of hardship are met should always be assessed considering the facts of the particular case; the existence of prior economic crises do not mean drastic changes in the economy cannot constitute hardship.

Common Law Perspective: the Frustration Theory

The Frustration Theory is different from its counterparts in Civil Law, both in terms of its conditions and consequences. The theory provides that a contract shall terminate in the event that the performance of an obligation becomes difficult as a result of rendered circumstances.

In addition to difficulty in performance, imbalance in the corresponding obligations of the parties, and frustration of the purpose of the contract as a result of a substantial change in circumstances, the theory also subsumes impossibility of performance in consequence of physical, legal, or commercial reasons. In this regard, if the main benefit sought by the parties at the conclusion of the contract is frustrated or the performance is no longer viable; the contract is terminated *ex officio*, *i.e.,* without the need for any party's request and even if the parties continue to perform their obligations. However, if the frustration only concerns a certain part of the contract, which may be separated from other parts, only rights and obligations arising from the said part of the contract may be assumed terminated.

Nevertheless, it is worth noting that the Frustration Theory has quite a narrow application. In its 1956 landmark decision, *Davis Contractors Ltd v Fareham Urban District Council* ([1956] UKHL 3), the UK House of Lords clarified that the mere existence of economic hardship did not suffice for application of the Frustration Theory. The decision states that the parties take certain commercial risks while entering into a contract, which may result in greater or lesser profit than expected. In order for the Frustration Theory to be applied, such hardships should be caused by situations or events that should be impossible to contemplate at the time of the conclusion of the contract. The *Thames Valley Power Ltd v. TOTAL Gas & Power Ltd* ([2005] EWHC 2208) decision dated 2005 -which is about an energy dispute- provides another instance for the narrow implementation of the frustration. The court has made the application of the Frustration Theory clear by rendering that a party cannot be relieved from a contract due to *force majeure* or frustration only because it has become too expensive to perform it.

In light of the above, Common Law systems seem less advantageous for the parties seeking a price review, when compared to the Civil Law systems' adaptation/renegotiation opportunity. Accordingly, it would be advisable to add clauses to a contract governed by Common Law that clearly allocate risk and responsibility between the parties, or stipulate an action plan, or a plan B in the event of unforeseeable changes in the circumstances. It would also be sensible to specify, in the contract, the core benefit expected from the agreement by the parties , if any, since it would make the resolution of a probable dispute regarding the frustration of the purpose of the contract much easier.

Conclusion

The unprecedented conditions that we currently live in require parties to energy trading contracts to be more cautious than ever. As a result, contracts are getting longer and more complex to cover any changing circumstances. However, when the contractual provisions fall short, the governing law emerges as a lifeline for the parties which struggle with price fluctuations. At that point, a governing law allowing adaptation or renegotiation may give a second chance to the parties to keep a deteriorated contract alive and to eliminate direct termination along with associated claims. Accordingly, governing law is more than a perfunctory choice in energy trading contracts; if mindfully chosen, it is a real game-changer.

**This content was originally published in Jus Mundi's Industry Insights Issue 5.*

Related Practices

- Corporate and Commercial Litigation
- Commercial Arbitration and Mediation

Related Attorneys

- C. HAZAL BAYDAR, LL.M.
- FULYA KURAR, LL.M.