Contract strategies against the recent 'disturbing' judicial doctrine regarding *rebus sic stantibus*[1] clauses

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Supreme Court judgment

The Spanish Supreme Court judgment 591/2014 of 15 October finds in part for the appellants in their *cassation* appeal[2] against the affirming judgment rendered by the *Audiencia Provincial* of Valencia (Eighth Chamber) on 29 June 2012.

On 25 February 1999, the parties entered into lease agreements for the purpose of using the buildings thereunder as hotels. The defendant undertook to construct three different blocks on one site: the first to be used as a two/three-star IBIS hotel (block H3), the second as a four-star NOVOTEL hotel (block H4) and the third, which is not subject matter of the lease agreements and was assigned to another hotel operator, as an aparthotel (block AH). The claimant undertook to occupy as lessee the abovementioned two new buildings intended for hotel use.

The lease had a term of 25 years as from handover, with five-year extensions unless one of the parties withdrew from the lease by giving twelve months' prior notice. The lessee was entitled to withdraw from the lease as of its tenth year, compensating the lessor with 15% of the rent it would have received had the initial 25 year term been observed. If the lessee terminated the agreement prior to the initial ten-year period, it would have to increase such amount by the total annual rent that would have accrued until the end of such ten-year period.

In the alternative, ACCOR HOTELES (the lessee) claimed a modification of the lease agreement in order to readjust the mutual consideration, with a reduction in the annual rent of 33% for the Novotel Hotel and 29% for the Ibis Hotel [the appeal with regards to the Novotel Hotel was subsequently dropped] to be applied as of the date of the claim or, alternatively, the date of the judgment. Also in the alternative, the claimant requested the court to hold the lease agreement as terminated and reduce the 15% penalty fixed for such contingency. The claim was rejected at trial and on first appeal in 2011 and 2012, respectively.

According to the judgment in the last resort, a reduction of the penalty does not lie as, according to doctrine established in the Supreme Court judgment of 7 April 2014, a reduction cannot be applied to 'penalties' [technically, 'break-up fees'] that do not arise from a breach by the promisor (as is the present case, which penalises the unilateral termination provided in the agreement, not a contractual breach).

However, the Supreme Court does accept the sixth ground of appeal, regarding the improper non-application of the *rebus sic stantibus* clause

[1] *Translator's note*: There is not an equivalent doctrine of *changed circumstances* in common law countries. However, through the court-constructed doctrines of *frustration, impossibility and impracticability*, common law countries have achieved similar outcomes.

[2] Translator's note: A last resort appeal on the grounds of a breach of the rules governing the determination of disputes.

[*hardship* or *frustration* clause], pursuant to the following legal doctrine.

According to the Supreme Court, "there has recently been a progressive shift in the traditional understanding of the highly restrictive scope of application". The judgment advocates, to the contrary, an "adaptation of institutions to the current social reality, as well as to the doctrinal application inherent to the legal sphere", leading to an application of the legal concept that is "fully standardised and where the necessary prudent application of the same does not derive from the above characterisation, but from its ineluctable casuistic application, from the requirements of its specific and differentiated technical basis and from its functional specificity in the context of the causal validity of the transactional relationship as determined by contractual unforeseeability and the breakdown of the contract's economic basis, resulting in excessive hardship to the party concerned." This recent trend is "already recognisable in the Supreme Court judgments of 17 and 18 January 2013", adding that "the current economic crisis, with the deep and prolonged effects of economic recession, can be openly considered as a phenomenon of the economy capable of generating a serious disorder or mutation of the circumstances, as has given shape in the recent judgment of 30 April 2014 with a detailed justification of the concept." [Note that the statement is unsound regarding the first two cases cited; neither judgment applied the *rebus* clause and, furthermore, both involved consumer contracts].

According to the Supreme Court, the judgment of the *Audiencia Provincial* commits the fallacy of begging the question, whilst "also avoiding the necessary casuistic treatment of the matter at issue, that is, the possibility of having provided a rental revision clause in that respect given the cyclical foreseeability of economic crises".

In the opinion of the Supreme Court, "part of the economic basis of the transaction" was formed by an economic context (between 1999 and 2004) of "unprecedented growth and expansion of demand accompanied too by an important urban development in the location area of hotels." Although the lessee is an expert in the sector and aware of the risks of this business, "the lack of foresight regarding the economic crisis cannot rest exclusively on its shoulders...; such risk cannot lie exclusively with the party at a disadvantage nor cannot it be reasonably established that it should have been taken into account in the natural allocation of risks arising from the concluded contract. In the city of Valencia, place of performance of the contract, earnings per hotel room fell by 42.3% in 2009, which led to closures and rent renegotiations under contracts in force." The fact that the lessor formalised in 2010 a new contract with another hotelier (HOTUSA) with a 50% reduction of the rent initially agreed in 2000 is "especially relevant". "Hence, unforeseeability should not be assessed in respect of an abstract possibility of alteration or factor determining a change per se, i.e., that an economic crisis is a cyclical event that one must always provide for, regardless of its specific nature and extent within the affected economic and social context." In addition, consideration was an excessive hardship with repeated losses of nearly three million euros in the period 2005-2009, "compared to the lessor's positive balance, standing at around 750,000 euros for the same period."

The judgment chooses to modify the agreement rather than terminating it, contending that such choice is the one most consistent with the principle of preservation of acts in the law (*utile per inutile non vitiatur*). The proposed 29% rent reduction "is in keeping with contractual adjustment", taking into account that, in spite of such reduction, the resulting rent is still 20% higher than current market rents "and far lower than the 50% rent reduction that the owner negotiated with the other hotel operator in competition with the claimant". This rent reduction shall be effective from the filing of the claim until the end of 2015, "as it is deemed in keeping with the time frame particularly affected by the changes in the analysed circumstances."

Assessment and future strategy

The Supreme Court judgment 591/2014 is debatable — as is its precedent, the Supreme Court judgment of 30 April 2014 — and anyone can anticipate the future repercussions of the legal doctrine it establishes. However, this is not the appropriate place to criticise the judgment; my intention, rather, is to suggest here a future strategy for negotiating contracts, based on the risks and (apparent) advantages such doctrine entails for corporate parties to long-term business or industrial leases.

Below follow some guidelines in terms of negotiating strategies, which take the judgment's doctrine as a

given. These guidelines are neutral: the client can be either the lessor or the lessee.

For reasons of brevity, I will omit explanations or arguments in favour of certain proposals which, perchance, may be considered odd at first glance.

1. There is no point in attempting to avoid the effects of the judgment with the apposition of a simple clause excluding the application of *rebus*, not because *rebus* is imperative, but rather because such exclusionary clause would itself be subject to *rebus*.

2. There is even less point in replicating in the agreement the *rebus* clause or a hardship clause similar to *rebus*. It is of no use to introduce a clause with indeterminate legal concepts if the specific conditions for its application are not also set out.

3. This judgment makes it impractical in the future to include a contractual *force majeure* clause in an attempt (which is otherwise reasonable) for it to be interpreted as meaning that the parties *did not wish* to include a more powerful or broader risk transfer clause such as the *rebus* clause. In other words, when a "sole" *force majeure* clause enters the contract, the right construction is not deeming that the parties have excluded other risk-allocation-clauses like *rebus* or similar.

4. The parties may agree on a range and ceiling for modifications which a judge or arbitrator may reasonably make in application of a *rebus* clause.

5. Even more so, the parties may agree that a supervening change in circumstances will only lead to a modification of the agreement when the imbalance reaches or surpasses a certain percentage (15% is common in the energy sector, where this type of clause is standard).

6. The *rebus* clause may be excluded by way of a unilateral or bilateral covenant conferring a right to withdraw with good cause to the party affected by the supervening risk. Break-up fees may even be agreed for such a case (always lower than the break-up fees for withdrawal without good cause); i.e., break-up fees even in the event of withdrawal with good cause.

7. Consideration may be pegged to indexes (other than the CPI), whereby changes in the market value of such consideration is internalized in the contract (negatively or positively). A benchmark index set on rental values excludes the additional application of the *rebus* clause.

8. The parties can agree to adjust the rent (either upwards or downwards) on a discontinued basis, escalating rents each (e.g.) five years, according to comparative market rents.

9. A clause excluding the application of the *rebus* clause is, in theory, valid, provided the parties expressly state that they know what they are waiving, especially if they make explicit reference to the material risks which are the business risk intrinsic to the field the parties operate in. This clause is valid, as are all clauses that "clearly" allocate a contractual risk to one of the parties.

10. The exclusion clause can also "select" those (sole) events that will lead to the application of the *rebus* clause upon their occurrence, as is the case with MAC (Material Adverse Change) clauses.

11. The parties may agree that in the event of a *rebus* clause being applicable, the only available option shall be termination, with no possibility of a judge adjusting or modifying the agreement.

12. The parties may agree that in the case of a court or arbitral modification, not only shall the consideration owed by the affected party be modified, but counterbalances shall also be created to compensate the other party (cf. an increase in the penalty clause, a reduction in the length of free withdrawal periods, a creation of ancillary obligations, etc.)

13. There can be no place for the application of the *rebus* clause if a Material Adverse Change clause has been agreed (whatever the content thereof). This clause allocates the relevant risks and the *rebus* clause cannot apply where the risks are properly allocated.

14. A duty to negotiate in good faith (within a defined period of time) can be agreed upon

before the affected party institutes the appropriate judicial or arbitral proceedings.

15. Although the erratic reasoning of the judgment precludes reliable predictions, a clause allowing only the promisor of non-pecuniary consideration — not the counterparty promisor of pecuniary consideration — to rely on the *rebus* rule should be valid.

16. If the above measures or precautions are not taken, the value of long-term contracts shall decrease, as will, therefore, the interest in "paying" over these long periods.