Risk Allocation in Frustrated Contracts: Building the Case for a New Sri Lankan Act

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Introduction

The freedom of contract allows parties to decide on the terms of a contract according to their own wishes. As a vitiating factor frustration of a contract is used as a method for terminating a contract. The Sri Lankan law governing doctrine of frustration is the Roman-Dutch law. However, as Judge Weeramantry observes (Weeramantry, 1967), with the evolvement of time both the common law and the civil law have come to similar terms with regard to their effect relating to the doctrine, and the distinctions that remain are purely theoretical. The judiciary has also been quite keen on adopting the more readily available English doctrines as a whole and it can be seen that the law now that governs the doctrine of frustration in practice is the English law.

The English law relating to frustration has changed from one of strict liability, where parties were held liable for their respective promises irrespective of events making performance not possible to a more liberal one, where parties were excused for events that resulted in non-performance, which were beyond their control, through developments in the common law. However, even with these changes in the common law it still yielded some unjust results which resulted in an imbalance of the risk allocation of frustrated contracts. The basic question then was to decide, who should bear the loss resulting from an event that has rendered performance by one party uneconomical (Posner and Rosenfield, 1977). To address these issues with the recommendations of the Law Commission the UK introduced The Law

Reform (Frustrated Contracts) Act, 1943, which dealt with allocating the risk of frustrated contracts on respective parties. The Act furnished the courts with the discretion to decide on the matters relating to the allocation of risks in particular circumstances. It primarily allowed the party proving frustration to get a discharge from their obligations while reserving discretionary powers with Court to decide on the just sum that could be allocated to the other party to the contract.

As it currently stands, the Sri Lankan law regarding frustration in practice is the English law (Weeramantry, 1967). However, since England has introduced an Act relating to frustration, our legal system is incapable of absorbing those statutory provisions, and the case law developed through those provisions. Therefore, according to the practices of our legal system we would have to rely on the case law that existed before the enactment of the English Act and hence we would have to rely on rejected and outdated precedents. The legal system should be equipped to take into consideration this lacuna in our legal system and a Sri Lankan Act relating to frustrated contracts should be enacted based on the English model as the English model has served as the basis for the Acts enacted in countries such as New Zealand, Australia and Canada on the issue of frustration.

Objective

The objective of this research is to suggest legal reform to an existing lacuna in the legal system regarding frustrated contracts. An Act regarding the allocation of risk regarding frustrated contracts based on the English model to enhance the efficacy of the exchange model is proposed as a way to reform the existing law.

Methodology

This is mainly a qualitative research based on a library research where primary sources of legislations and case laws are used and as secondary sources commentaries on the English Act and case laws are used.

Results and Discussion

The English Act was able to provide better solutions for two particular problems which the common law had created. Under section 1(2) of the Act all obligations that arose prior to the frustrating event were discharged and

anything paid was recoverable and anything to be paid ceased to be payable. This allocated the risk on the party which was not relying on frustration. However, the party alleging frustration was not able to take all and leave. The court was given a discretion to allocate some of the risk on the party relying on frustration by allowing the other party to take back incurred expenses prior to the frustrating event (Gamerco SA v ICM/Fair Warning Agency, [1995]). In this case it was held that the court is given a broad sense of discretion to do justice in a situation which the parties had neither contemplated nor provided for, and to mitigate the possible harshness of allowing all loss to lie where it has fallen. This provision is a proportionate way of balancing the allocation of risk and should be included in a Sri Lankan Act if one is to be made.

The other important provision in the UK Act is section 1(3) which again gives the court discretion as to give compensation for the party who has provided some kind of value to the other party before the discharge of the contract to have a *just sum* accordingly. This provision has given some difficulty in interpretation and as Lord Goff (BP Exploration Co (Libya) Ltd v Hunt (No 2), [1982]) has observed what matters is the end product and not the value of the work that had been already done. This interpretation, if one is to accept it as correct would undermine the whole rationale of the UK Act and would make it futile. For this reason, this observation has been severely criticized by the likes of Treitel (Treitel, 1994) and Mckendrick (Mckendrick 1995). It is observed that this provision should be utilized in a slightly modified manner in that the courts should be given discretion to order compensation on the party who had incurred expenses irrespective of a benefit being passed to the other party or not. However, this discretion should be of a limited nature than the one outlined under section 1(2) of the UK Act and should merit a proportionality approach. The discretion given should be used to serve justice to all and the relative losses of the parties should be proportionately allocated among them having regard to the context and nature of the case.

There have been many theories presented in regard to juristic basis underlining the doctrine of frustration and one basis on the implied term is now disregarded while the economic analysis has taken precedent. The *superior risk bearer's* theory advanced by Judge Posner which looks for the

party who could have better mitigated the situation may also provide a good basis for a risk allocation theory to be embedded in the proposed Sri Lankan Act on the matter. However, at times our courts have gone onto a more extravagant and dangerous basis of a just and reasonable solution theory (Eliyathamby v. Mirando, [1948]) and this theory has been disapproved by the English Courts. In addressing this, the proposed Act could be based on an economic analysis of the risk allocation relating to frustrated contracts which seems to provide a vibrant solution and a better theoretical basis out from the rest.

The research has also shown that most of the contracts themselves allocate the risks in relation to frustration through a *force majeure* clause. By including a *force majeure* clause, the parties themselves decide on the proper allocation of risk relating to a discharge of the contract through a frustrated event. The contracting parties find this much more economical and efficient than to contest the effects of frustration in a court of law. This gives the opportunity for the parties to a contract to decide upon the allocation of the risk according to their own capabilities which is the best suited solution for the exchange model which always tries to create a surplus through the exchange.

The part played by market insurance has to be taken into consideration as well. However, it must be remembered that market insurance comes at a price and may not be suitable for all circumstances. However, it is further observed that though the parties may themselves assign the risk of a failure to perform their part of the obligation since the bargaining powers are never equal this inequality will create a problem for an optimum risk allocating mechanism. Further, where a *force majeure* clause is vague or ambiguous, frustration will be applicable. Therefore, the courts must be given the opportunity to intervene in appropriate circumstances to make the exchange model work. Here again the discretionary natures of the power given to the courts will be of vital importance. It should neither be too loose nor strict and should be capable of accommodating the evolutionary nature of the society.

Conclusion

Introducing an Act for Sri Lanka relating to the allocation of risk with regard to frustrated contracts would help to fill in the gaps that exist in the legal

system regarding frustrate contracts. Though *force majeure* clauses and insurance has significantly contributed to the allocation of risk relating to frustrated contracts judicial intervention has not been significantly reduced as a result in deciding on the fairness of the risk allocation. Therefore, it would be a feasible idea to have a modified version of the English Act in Sri Lanka to aid the judiciary to allocate the risk at an optimum level regarding frustrated contracts. It is to be recognized that risk-bearing is a perpetual question of business activity, and that frustration is a device for addressing it and we can address it better with a statutory enactment to that effect.

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