In Theory

Renegotiating Existing Agreements: How to Deal with "Life Struggling Against Form"

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Renegotiation of existing agreements is constant in all areas of life. In this article, the author examines the nature and causes of renegotiation and offers guidance to persons involved in the renegotiation process. He identifies three distinct types of renegotiations — post-deal, intra-deal, and extra-deal renegotiation. Each of the three types poses particular problems and opportunities and each requires different techniques to deal with those problems and opportunities.

Despite lengthy discussions, skilled drafting, and strict enforcement mechanisms, parties to solemnly signed and sealed agreements often find themselves returning to the bargaining table later on to "renegotiate" them. Thus, a key challenge in negotiating any agreement is not just "getting to yes" but also staying there.

The renegotiation of existing agreements is a constant in all areas of life. Economic recessions or significant changes in prices invariably lead to restructurings and workouts of thousands of business arrangements made in better times. Companies facing financial crises sometimes try to find a solution to their problems by renegotiating their labor contracts. In the international arena, the world has witnessed the renegotiation of mineral and petroleum agreements of the 1960s and 1970s, often in the face of threatened host country nationalizations and expropriations; the loan

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reschedulings of the 1980s following the debt crisis in developing countries; and the restructuring of project and financial agreements as a result of the Asian financial crisis of the late 1990s. In 2001, the American government launched a major foreign policy initiative by asking Russia to renegotiate the Anti-Ballistic Missile Treaty so the U.S. could develop a missile defense system. Later this same year, the terrorist attacks in New York and Washington on September 11 inaugurated a new era of insecurity that has prompted the review and renegotiation of existing agreements in many domains.

Through renegotiation, business executives, lawyers, and government officials continually seem to be seeking either to alleviate a bargain that has become onerous or to hold onto a good deal that the other side wants to change. The examples are so numerous that renegotiating existing agreements seems as basic to human relations as is negotiating new agreements. Seventy years ago, Karl Llewellyn, a noted American legal scholar, captured the tension between negotiated agreements and subsequent reality in the conclusion of his thoughtful inquiry into the role of contract in the social order: "One turns from the contemplation of the work of contract as from the experience of Greek tragedy. Life struggling against form. . ." (Llewellyn 1931: 751). Renegotiation is one of the most important theaters in which parties to existing agreements play out the continuing struggle of life against form.

The purpose of this article is to examine the phenomenon of renegotiation, to explore its nature and causes, and to offer advice on how best to conduct the renegotiation process.

The Three Types of Renegotiation

Discussions of renegotiation apply the term to three fundamentally different situations, each of which presents different problems that require different solutions. The three situations are: post-deal renegotiations; intra-deal renegotiations; and extra-deal renegotiations.

Post-deal renegotiation takes place at the expiration of a contract when the two sides, though legally free to go their own way, nonetheless try to renew their formal relationship. For example, consider the case of a power company which has built an electrical generating station and entered into a twenty-year contract to supply electricity to a state public utility. At the end of twenty years, when local law considers their legal relationship at an end, the power company and the public utility begin discussions on a second long-term electricity supply contract, thereby renegotiating their original relationship. While this second negotiation process — a post-deal renegotiation — may at first glance seem to resemble the negotiation of their original contract, it also has some notable differences that influence renegotiation strategies, tactics, and outcomes.

Intra-deal renegotiation occurs when the agreement itself provides that, at specified times or as the result of specified events occuring during

the term of the contract, the parties may renegotiate or review certain of its provisions. For example, the just-mentioned electricity supply contract might include a provision calling for the renegotiation of the agreement's pricing terms in the event of dramatic changes in fuel costs, which could occur over a 20-year period. Here renegotiation is anticipated as a legitimate activity in which both parties, while still bound to each other in a valid contract, are to engage in good faith. It is an intra-deal renegotiation because it takes places within the legal framework established for the original transaction.

The most difficult, stressful, and emotional renegotiations are those undertaken in apparent violation of the contract or at least in the absence of a specific clause authorizing a renegotiation. These negotiations take place extra-deal, for they occur outside the framework of the existing agreement. The negotiations to reschedule loans following the Third World debt crisis of the early 1980s, the effort by the American government to renegotiate the ABM Treaty with the Russians, and attempts by companies to secure changes in existing union contracts all fit within the category of extra-deal renegotiations. In each case, one of the participants is seeking relief from a legally binding obligation without any basis for renegotiation in the agreement itself.

Renegotiation has thus become a constant and ever-present fact of contemporary life, whether it is post-deal, intra-deal, or extra-deal. Renegotiation can be distinguished from initial negotiations by three factors that significantly affect the renegotiation process itself. They are: *increased mutual knowledge; increased transactional understanding;* and *increased mutual linkage*. First, as a result of working together during their first agreement, the parties know much more about each other than when they first negotiated that agreement. Second, many of the questions that they had about their contemplated transaction during the initial negotiation have now been answered. And third, as a result of their investments in the transaction during the first agreement, it may now be more costly to abandon renegotiations than it was to have walked away from the initial negotiations

In each type of renegotiation, different relationships and process dynamics are taking place among the parties. These dynamics lead to possible strategies and tactics that are worthy of consideration by thoughtful negotiators. Let's examine the processes at work in the three kinds of renegotiation.

Post-Deal Renegotiations

Although a post-deal renegotiation takes place when the original transaction has reached or is approaching its end, several factors distinguish it from a negotiation in first instance, factors that may also significantly affect the renegotiation process. First, by virtue of law, custom, or express or implied contractual commitments, the parties may have a legal obligation

to negotiate in good faith with one another despite the fact that their original contract has terminated; consequently, their ability to refuse to engage in post-deal renegotiations may be limited. The existence and precise nature of such a duty will depend on the law governing the contract.

Anglo-American law traditionally has recognized a broad, unrestrained freedom of negotiation that permits a party to begin or end negotiation at any time for any reason (Farnsworth 1987: 220-221). The rationale for this rule is that a limitation on the freedom to negotiate might discourage persons from undertaking transactions in the first place. By contrast, the law in certain other countries is a less liberal, holding that once the parties have commenced negotiations, they may have an obligation to negotiate in good faith (Litvinoff 1997: 1659-1662).

But even in common law countries, the parties may have an obligation to renegotiate an agreement in good faith at its end because of an express provision in the original contract; the prevailing practices and customs of the business concerned; or the conduct of the parties toward one another during the life of their agreement. In contrast, parties seeking to negotiate a transaction in first instance have no such obligation and can abandon negotiations at any time.

The precise content of the obligation to renegotiate in good faith an existing negotiated agreement varies from country to country. It may include a duty not to negotiate with a third person until post-deal negotiations with a party in the original transaction have failed. Or, it may also require a party not to terminate renegotiations without reasonable cause and without having persevered for a reasonable length of time (Farnsworth 1987: 269-285). Failure by either side to fulfill its obligations to renegotiate in good faith may result in liability in damages.

Even if the applicable law imposes no legal obligation to renegotiate in good faith, the original contract, as well as current economic factors, may constrain the post-deal renegotiation process in ways not present in the original negotiations. For example, the twenty-year electricity supply contract mentioned earlier might provide that, if the power company and the public utility fail to negotiate a second twenty-year supply contract, the public utility company will be obligated to purchase the project company's electrical generating station according to a pricing formula specified in the original agreement.

Beyond the legal and contractual constraints, the parties' increased mutual knowledge, increased transactional understanding, and increased mutual linkage will significantly influence the course of negotiations. For example, in renegotiating the electricity supply agreement, the power company's approach will be more cautious and reluctant if the history of the first contact was plagued by late and contested payments than if the public utility had always paid on time and in full. Similarly, if over the first twenty years the price of power under the contract had proven to be much higher than competing forms of energy, the public utility would

seek changes in the pricing formula during the renegotiation. Finally, the fact that the power company organized itself and trained its employees to provide electricity over the long term to a single specific purchaser will probably mean that, all other things being equal, the power company would prefer to enter into a new contract with the utility rather than to make an agreement with another purchaser, a course of action entailing significant new risks and costs. Then too, the public utility, having come to rely on the power company for a major portion of its electrical supply, may wish to avoid the costs of finding another supplier or creating its own electrical generating capacity.

In any negotiation, a party's actions at the negotiating table are influenced by its evaluation of available alternatives to the deal it is trying to negotiate. Rational negotiators will not ordinarily agree to a transaction that is inferior to their best alternative to a negotiated agreement, or BATNA (Fisher, Ury and Patton 1991: 99-102). In a post-deal renegotiation, each party's evaluation of its BATNA will be heavily influenced by knowledge of the other side obtained during the first agreement, its understanding of the transaction gained during that time, and the extent of the investment that it has made in the relationship.

In general, the success of post-deal renegotiations will depend on the nature of the relationship that developed between the parties during the original contract. If that relationship was strong and productive, the atmosphere at the renegotiation bargaining table will be that of two partners trying to solve a common problem. However, if the relationship was weak and troubled during the term of the initial agreement, the prevailing mood will be that of two cautious adversaries who know each other only too well.

These factors give rise to three general principles that negotiators should consider as they structure and conduct the process of post-deal renegotiations:

1. *Provide for post-deal renegotiations in the original contract.* In transactions in which the desirability or likelihood of post-deal renegotiations is high, the parties should specify in their original agreement the process and rules that they will follow in conducting a post-deal renegotiation. For example, among other similar provisions, the contract should specify such matters as how soon before the end of the contract term that renegotiations are to begin; how long the renegotiations are to continue before either party may legally abandon them; where the renegotiations are to take place; and the nature of the information that each side is to provide the other. Recognizing that post-deal renegotiations may become problematic, the contract might also authorize the use of mediators or other third-party helpers in the process.

2. *Individually and jointly review the history of the relationship during the original contract.* As part of its preparation, each party to a post-deal renegotiation should review, carefully and thoroughly, the experi-

ence of working with the other side during the first contract. An understanding of the problems encountered during that period will enable each side to shape proposals to remedy them during a contemplated second agreement. To make that review an opportunity for creative problem solving rather than mutual acrimony over past mistakes, the parties should structure a joint review of past experience, perhaps with the help of a neutral facilitator, at the beginning of the post-deal renegotiation process. For example, as a first step in the renegotiation process, the power company and the public utility might give a review team consisting of executives from each side the task of preparing a mutually acceptable history of their relationship. Inevitably, during the course of post-deal renegotiations, each side will refer to past events. The renegotiation process will proceed more smoothly and efficiently if, at the beginning of the process, the parties have a common understanding of their history together than if they engage in a continuing debate throughout the renegotiation about the existence and significance of past events.

3. *Understand thoroughly the alternatives to a renegotiated deal.* Negotiators should not only evaluate their own alternatives to the deal that they are trying to make but they should also try to estimate their counterparts' alternatives. In a post-deal renegotiation, these two tasks are often complicated by the fact that the parties may have conducted their activities in such a way during the first contract that few realistic alternatives to a second contract seem possible. For example, the power company that owns a generating facility may feel that it has few other options than to enter into a second contract with the state public utility. Or the public utility company, in time of energy shortage, may see no realistic alternatives to making a second electricity power purchase agreement with the project company. Rather than to accept the inevitability of a second contract, each side, long before the termination of the first contract, should carefully examine all options and seek to develop possible new alternatives before entering into post-deal renegotiations with the other side. For example, the state public utility, perhaps several years in advance of the end of the first contract, should contact other potential project companies to determine their interest in developing electrical generation plants.

Intra-Deal Renegotiations

Contractual stability is a goal sought by all sides in any negotiation. Parties to a contract obviously need the assurance that the terms of their agreement will be respected in the future. At the same time, most parties know that unforeseen events may arise during a contract term that drastically change the balance of benefits originally contemplated by their agreement. Consequently, a fundamental challenge in contracting practice is to achieve contractual stability but, at the same time, allow the parties to deal with changing circumstances in the future. The traditional approach to resolving this dilemma is for the parties during their original negotiation to

attempt to anticipate all possible contingencies and to provide solutions for them in their agreement. This approach rejects the idea of intra-deal renegotiation.

Another solution to the problem of balancing the imperatives of stability and change is for the contract itself to authorize the parties to renegotiate key elements of their relationship, should specified events or circumstances occur. In view of the impossibility of predicting all possible future contingencies, the inclusion in the agreement of some type of intra-deal renegotiation clause would appear to be a useful device to give needed flexibility to long-term agreements. In fact, however, western organizations rarely use them.

The traditional reluctance to use renegotiation clauses stems from a variety of factors, both legal and practical. First is the concern among lawyers that renegotiation clauses are merely "agreements to agree" and therefore may be unenforceable (Carter 1999: 188). On the other hand, although English common law has tended to dismiss agreements to negotiate as unenforceable, the contemporary approach in most American courts is to enforce agreements to negotiate in good faith. According to one recent case from a U.S. Federal District Court, "the critical inquiry in evaluating the enforceability of an express or implied agreement to negotiate in good faith is whether the standard against which the parties' good-faith negotiations are to be measured is sufficiently certain to comport with the applicable body of contract law." (Howtek, Inc. v. Relisys et al. [1999]). It would seem that a specific renegotiation clause in an existing contract with definite terms as to how the parties are to conduct the renegotiation process would easily meet this standard of enforceability. The required certainty would be further satisfied by specifying the precise events that give rise to the obligation to renegotiate and by specifically providing for the timing, locale, and conditions of the renegotiation process, among others.

Practical considerations have also led western executives to view renegotiation clauses with suspicion on grounds that they increase uncertainty and risk in transactions and offend western concepts of the "sanctity" of contract. Their presence in a contract also creates a risk that one of the parties will use a renegotiation clause as a lever to force changes in provisions that, strictly speaking, are not open to revision. The challenge of drafting these provisions and the heightened risks to contractual stability by renegotiation clauses that have yet to be tested in the courts are additional factors that have deterred their use in long-term contracts.

Despite these potential pitfalls, the inclusion of a renegotiation clause may actually contribute to transactional stability in certain situations. First, in cases in which significant changes in circumstances may result in severe unexpected financial hardship, a renegotiation clause may permit the parties to avoid default, with the attendant risk of litigation and extra-deal renegotiations. During the original negotiations, it may be wiser for the parties to recognize the risk of changed circumstances and create within the contract a process to deal with them rather than to try to predict all

eventualities and then be subject to the uncertain decisions of courts when those predictions prove to be flawed.

A second situation in which a renegotiation clause may be helpful occurs in cases in which the parties, by virtue of their differing cultures, understand and perceive the basis of their transaction in fundamentally different ways. For example, western notions of business transactions as being founded upon law and contract often clash with Asian conceptions of business arrangements as based on personal relationships (Salacuse 1998: 225-227). In some Asian nations, executives often consider the essence of a business deal to be the relationship between the parties, rather than the written contract, which in their view can only describe that relationship imperfectly and incompletely. They may also assume that any long-term business relationship includes an implicit, fundamental principle: in times of change, parties in a business relationship should decide together how to cope with that change and adjust their relationship accordingly.

However, the western party may view the long-term business transaction as set in the concrete of a lengthy and detailed contract without the possibility of modification. This sharply contrasts with the Asian side viewing the transaction as floating on the parties' fluid personal relationships, which always have within them an implicit commitment to renegotiate the terms of the transaction in the event of unforeseen happenings.

In long-term transactions, such as joint venture project between Asian and western companies whose success depends on close and continuing cooperation, it may be wise to recognize this difference of view at the outset of negotiations and attempt to find some middle ground. A renegotiation clause may represent such middle ground between total contractual rigidity on the one hand and complete relational flexibility on the other. It recognizes the possibility of redoing the deal, but controls the renegotiation process. An intra-deal renegotiation clause, then, may give stability to an arrangement whose long-term nature creates a high risk of instability.

The use of renegotiation clauses in long- term agreements seems to be on the increase in recent years (Carter 1999: 189). A variety of intra-deal renegotiation clauses exist to cope with the challenge of balancing contractual stability with adaptation to change. The following are some of the principal types:

1. *The implicit minor renegotiation clause.* Despite some lawyers' claims to the contrary, contracts in long-term arrangements, no matter how detailed, are not a kind of comprehensive instruction booklet that the parties follow blindly. At best, such agreements are *frameworks* within which the participants constantly adjust their relationship. Karl Llewellyn (1931: 736-737) underscored this point many years ago when he wrote:

> . . .the major importance of a legal contract is to provide a framework for well-nigh every type of group organization and for well-nigh every type of passing or permanent relation between individuals and groups, up to and including states — a framework highly adjustable, a framework which almost never accurately indicates real working relations, but which affords a rough indication around which such relations vary, an occasional guide in cases of doubt, and a norm of final appeal when the relations cease in fact to work.

Executives responsible for implementing long-term transactions have consistently confirmed Llewellyn's observation in similar terms: "Once the contract is signed, we put it in the drawer. After that, what matters most is the relationship between us and our partner, and we are negotiating that relationship all the time." What this view means in practice is that certain matters in the agreement, usually but not always of a minor nature, are subject to renegotiation by the parties as part of their ongoing relationship, despite the fact that their contract contains no specific renegotiation clause (Kolo and Walde 2000: 45).

One can therefore argue that an "implicit minor renegotiation clause" is part of any transaction agreement. For example, if a long-term supply agreement provides that the supplier make deliveries in a country on June 30 of each year, but the government of the country later declares a national holiday on that date, making it difficult for the public utility to accept delivery, the parties would renegotiate a more appropriate time for delivery.

2. *Review clauses.* Long-term contracts, particularly in the oil and mineral industries, sometimes commit the parties to meet at specific times to review the operation of their agreement. For example, one mining agreement provided that the parties were to meet together every seven years "with a view to considering in good faith whether this Agreement is continuing to operate fairly. . .and with a view further to discussing in good faith any problems arising from the practical operation of this agreement" (Peter 1995: 79). Although the words "negotiation" or "renegotiation" appear nowhere in this clause, one reasonable interpretation of the provision is that it carries an implicit obligation for the parties to resolve problems through good-faith negotiation.

3. *Automatic adjustment clauses.* Transaction agreements often contain certain terms, such as those concerning prices or interests rates, subject to automatic change by reference to specified indices, such as a cost-of-living index or the London Interbank Offered Rate (LIBOR). For example, the electricity supply contract might link the price to be paid for the electricity by the public utility to variations in fuel costs or the local cost-of-living index. While the aim of such a provision is to provide for flexibility without the risks inherent in renegotiation, negotiation may still be necessary to apply the index in unanticipated situations or in the event

that the index itself disappears or becomes inappropriate (Kolo and Walde 2000: 44).

4. *Open-term provisions.* Because of the difficulties and risks inherent in trying to negotiate arrangements to take place far in the future, some transaction agreements specifically provide that certain matters will be negotiated at a later time, perhaps years after the contract has been signed and the transaction implemented. For example, a foreign investor seeking approval for a factory from a host government might agree to negotiate appropriate senior management training schemes after it has constructed the facility and begun to hire local managers. This type of provision might be called an "open-term" clause because the matter in question has been left open for negotiation at a later time (Farnsworth 1987: 250).

In a strict sense, of course, the subsequent negotiation of an open term is not really a renegotiation of anything, since the parties have not yet agreed on any elements of that provision. In a broader sense, however, the negotiation of an open term at a later time will have the effect of modifying the overall relationship among the parties. Moreover, it is not inconceivable that one or more of the parties could use the opportunity of negotiating the open term as an occasion to seek concessions or changes in other terms through the common negotiating device of linking issues. For example, the foreign investor might offer the host government a particularly attractive management training program if the government would agree to certain desired regulatory changes.

5. *Formal renegotiation clauses.* In an effort to balance the imperatives of contractual stability with flexibility, long-term agreements sometimes contain formal wording that obligates the parties to renegotiate specified terms affected by changes in circumstances or unforeseen developments, such as those concerning construction costs, governmental regulations, or commodity prices. For example, an oil exploration contract between the Government of Qatar and a foreign oil company provided that the two sides would negotiate future arrangements for the use of natural gas not associated with oil discoveries if commercial quantities of such "non-associated" gas were later found in the contract area (Carver and Hossain 1990: 311). In addition, renegotiation clauses in investment contracts often accompany stabilization clauses by which a host country promises that any changes in laws or regulations will not adversely affect the foreign investment project. The effect of the two clauses is to obligate the host government and the project company to enter into negotiations to restore the financial equilibrium which such new laws and regulations may have destroyed.

An intra-deal renegotiation clause obligates the parties only to negotiate, not to agree. If the two sides have negotiated in good faith but fail to agree, that failure cannot justify liability on the part of one of the parties. In order to bring finality to the process of intra-deal renegotiation, long-

term agreements sometimes include a "contract adaptation clause," which stipulates that when certain specified events occur, the parties will first seek to negotiate a solution and, failing that, refer their problem to a third party for either a recommendation or a binding decision, depending on the desire of the parties to the contract. Certain institutions, such as the International Chamber of Commerce, have developed rules and facilities to help carry out the contract adaptation process.

Extra-Deal Renegotiation

In an extra-deal renegotiation, one party is insisting on renegotiating terms of a valid contract that contains no express provision authorizing renegotiation. Unlike negotiations for the original transaction, which are generally fueled by both sides' hopes for future benefits, extra-deal negotiations usually begin with both parties' shattered expectations. One side has failed to achieve the benefits expected from the transaction, and the other is being asked to give up something for which it bargained hard and which it hoped to enjoy for a long time. And whereas both parties to the negotiation of a proposed new venture participate willingly, if not eagerly, one party always participates reluctantly, if not downright unwillingly, in an extra-deal renegotiation.

Beyond mere disappointed expectations, extra-deal renegotiations, by their very nature, can create bad feeling and mistrust. One side believes it is being asked to give up something to which it has a legal and moral right. It views the other side as having gone back on its word, as having acted in bad faith by reneging on the deal. Indeed, the reluctant party may even feel that its is being coerced into participating in extra-deal renegotiations since a refusal to do so would result in losing the investment it has already made in the transaction.

In most cases, it is very difficult for the parties to see extra-deal renegotiations as anything more than a process in which one side wins and the other side loses. While the negotiation of any transaction initially is usually about the degree to which each side will share in expected benefits, an extra-deal renegotiation is often about allocating a loss. At the same time, because the parties are bound together in a legal and economic relationship, it is usually much more difficult for one or both of them to walk away from a troubled transaction than it is for two unconnected parties to a proposed agreement in first instance.

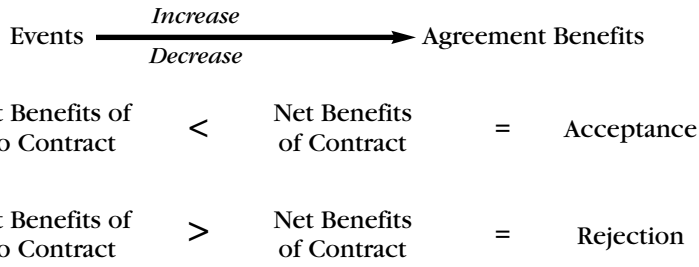
In most countries, the law does not oblige a party to enter into renegotiations, no matter how much conditions have changed or how heavy the costs incurred by the other side since the contract was originally made (Carter 1999: 185).[1] In general, a party being asked to renegotiate an existing agreement has a legal right to refuse to renegotiate and to insist on performance in accordance with the letter of the contract. On the other hand, requests — or in some cases, demands — for renegotiation of an existing agreement are often accompanied by express or implied threats,

including governmental intervention, expropriation, a slowdown in performance, or the complete repudiation or cancellation of the contract itself.

Parties facing a demand for renegotiation usually have an available legal remedy to enforce their existing contract and will often threaten to go to court to assert it. However, a willingness to pursue a legal remedy to its conclusion, rather than renegotiate, will usually depend on the party's evaluation of that remedy in relation to the results it expects from renegotiation. To the extent that the net benefits (i.e., benefits minus costs) from renegotiation exceed the expected net benefits from litigation, a rational party will ordinarily engage in the requested renegotiation. But if either before or during the renegotiation, a party decides that the net benefits to be derived from litigation will exceed the net benefits to be gained in renegotiation, that party will normally pursue its legal remedies.

On its side, the party asking for renegotiation will be making its own cost-benefit analysis of the relative merits of contract repudiation and its probable fate in litigation. As long as this party believes that the net benefits of repudiating the contract are less than the net benefits of respecting it, the contractual relationship will continue. But when (for whatever reason) it judges the respective net benefits to be the opposite, the result will be a demand for renegotiation with the threat of eventual repudiation in the background. Figure One seeks to capture this dynamic.

Figure One
Assessing the Effects of Changing Circumstances



A party's reluctance to agree to an extra-deal renegotiation may be due not only to the impact of renegotiation on the contract in question but on other contracts and relationships as well. Renegotiation of a transaction with one particular party may set an undesirable precedent for other renegotiations with other parties. For example, concessions by a union to one employer may lead another employer to seek equal treatment by demanding extra-deal renegotiations of its own labor agreements.

Although the causes of extra-deal renegotiations in individual cases are numerous, they generally fall into one of two basic categories: (1) the

parties' imperfect contract with respect to their underlying transaction; and (2) changed circumstances after they have signed their agreement.

1. *The parties' imperfect contract.* The goal of any written contract is to express the full meaning of the parties' agreement concerning their proposed transaction. Despite lawyers' belief in their abilities to capture that agreement in lengthy and detailed contracts, in practice a written contract, particularly in long-term arrangements, can only achieve that goal imperfectly, largely for three reasons. First, the parties to long-term agreements are inherently incapable of predicting all of the events and conditions that may affect their transactions in the future because that would require perfect foresight. Second, the transaction costs of making contracts limit the resources that the parties are able to devote to the contracting process and thus further restricts the ability of the parties to make a contract that perfectly reflects their understanding (Talley 1999: 1206; Tracht 1999: 623-624). Third, even if the parties had the requisite foresight and resources to draft a perfect contract, they have no assurance that a court will interpret their contract exactly as they intended.

Adding even more complexity to the problem of accurately negotiating and articulating the parties' intent in a long-term international transaction are the parties' differing cultures, business practices, ideologies, political systems and laws — factors that often impede a true common understanding and inhibit the development of a working relationship (Salacuse 1991).

2. *Changed circumstances.* Changes in circumstances since the time of the original contract are a second major cause for post-deal renegotiations. A sudden fall in commodity prices, the outbreak of civil war, a terrorist attack, the development of a new technology, or the imposition of currency controls are examples of changes in circumstance that often force the parties back to the negotiating table. As Raymond Vernon argued over three decades ago with respect to foreign investment projects, a bargain once struck will inevitably become obsolete for one of the parties and issues once agreed upon will be reopened at a later time. Long-term agreements, in Vernon's words, are obsolescing bargains" (Vernon1971: 46).

Generally speaking, changes in circumstances can either increase or decrease the costs and benefits of the agreement to the parties. As Figure One shows, when a change in circumstances means that the cost of respecting a contract for one of the parties is greater than the cost of abandoning it, the result is usually rejection of the deal or a demand for its renegotiation. The notions of "costs" and "benefits" are not limited to purely economic calculations. Political and social costs and benefits must also be accounted for. For example, in one case involving an investment project to build a luxury resort near the Giza Pyramids in Egypt, the Egyptian government originally signed the agreement because it believed the economic benefits of the project to exceed its potential costs. But when public and international opposition became strong and persistent, the gov-

ernment cancelled the project because it judged the political costs to outweigh the economic benefits to be derived from its construction.

Since the risk of extra-deal renegotiation is always present in any agreement, negotiators should ask themselves two basic questions:

- How can the likelihood of extra-deal renegotiations be reduced?; and
- When renegotiations actually occur, how should the parties conduct them to make the process as productive and fair as possible?

In answering these questions, negotiators need to distinguish actions they should take before and after the transaction has broken down and one party is demanding renegotiation or threatening to reject the deal entirely. Some renegotiation principles to folow before deal break-down include:

1. *Recognize that a signed contract does not necessarily create a relationship.* For a long-term transaction to be stable and productive for both sides, it must be founded on a relationship, a complex set of interactions characterized by cooperation and trust. A relationship also implies a connection between the parties. It is the existence of a solid relationship between the parties to a transaction that allows them to face unforeseen circumstances and hardships in a productive and creative manner.

A contract, no matter how detailed and lengthy, does not create a business relationship. Just as a map is not a country, but only an imperfect description thereof, a contract is not a business relationship, but only an imperfect sketch of what the relationship should be. A contract may be a necessary conditions for certain kinds of relationships, but it is usually not a sufficient condition.

While negotiators must be concerned about the adequacy of contractual provisions, they should also seek to determine that a solid foundation for a relationship is in place. Accordingly, a negotiator should also ask a variety of noncontractual questions during the negotiating process: How well do the parties know one another? What mechanisms are in place to foster communications between the two sides after the contract is signed? To what extent are there genuine links and connections between the parties to the agreement? Is the deal balanced and advantageous for both sides?

Regardless of culture, in most countries whenever one party fails to respect its contractual obligations to another party, the existence of a valuable relationship between the parties is more likely to facilitate a negotiated resolution of their dispute than if no such relationship exists. The reason for this phenomenon is that the aggrieved party views the relationship with the offending party as more valuable than the individual claim arising out of the failure to honor the contractual provision. Thus in a workout, a bank is often willing to renegotiate a loan with delinquent debtor company or country when the bank considers that the prospect of future business with the debtor is likely. Bondholders of the same debtor,

on the other hand, will generally be more resistant to renegotiation than banks since bondholders generally do not have the same opportunity for a profitable business relationship in the future.

2. *Building a relationship takes time, so don't rush initial negotiations.* Negotiators who are concerned to lay the foundation for a relationship as well as to conclude a contract know that sufficient time is required to achieve this goal. While speed of negotiation may appeal to Americans as "efficient" and a recognition of the fact that "time is money," for other cultures a quick negotiation of a complicated transaction may imply overreaching by one of the parties, insufficient consideration of the public interest, or even corruption.

A negotiation done in haste invites renegotiation later on. For example, in one case that attracted significant media attention in the mid-1990s, the fact that Enron, a major American energy company, negotiated a memorandum of understanding with the Maharashtra state government in India to build a $2 billion power plant after just three days of discussions during Enron's first visit to the Indian state made the subsequent power purchase agreement vulnerable to challenges from many quarters. Ultimately, the two sides were only able to resolve their conflict through a lengthy extra-deal renegotiation that changed important terms in the twenty-year contract by which Enron's project was to sell electricity to the Maharashtra State public utility (Salacuse 2001: 1342-1357).

3. *Provide for intra-deal renegotiations in appropriate transactions.* If the risk of change and uncertainty is constant in long-term agreements, how should dealmakers cope with it? The traditional method is to write detailed contracts that seek to foresee all possible eventualities. Most modern contracts deny the possibility of change. They therefore rarely provide for adjustments to meet changing circumstances. This assumption of contractual stability has proven false time and time again.

As suggested earlier, rather than to view a long-term transaction as frozen in the detailed provisions of a lengthy contract, it may be more realistic to think of a long-term agreement as a *continuing negotiation* between the parties as they seek to adjust their relationship to the rapidly changing environment in which they must work together. Accordingly, the parties should consider providing in their contract that, at specified times or on the happening of specified events, they will renegotiate or at least review certain of the contract's provisions.

In this approach, the parties deal with the problem of renegotiation before, rather than after, they sign their contract. Both sides recognize at the outset that the risk of changed circumstances is high in any long-term relationship and that at sometime in the future either side may seek to renegotiate or adjust the contract accordingly. Rather than dismiss the possibility of renegotiation and then be forced to review the entire contract at a later time in an atmosphere of hostility between the partners, it may be

better to recognize the possibility of renegotiation at the outset and set down a clear framework to conduct the process.

4. *Consider a role for mediation or conciliation in the deal.* A third party can often help the two sides with their negotiations and renegotiations. Third parties, whether called mediators, conciliators, or advisers, can assist in building and preserving business relations and in resolving disputes without resort to litigation. Consequently, negotiators should consider the possibility of building into their transactions a role for some form of mediation. For example, the contract might provide that before either party can resort to litigation to settle a dispute, they must use the services of a mediator or conciliator for a specific period of time in an attempt to negotiate a settlement of their conflict.

* * * *

When one side has demanded renegotiation of the basic contract governing their relationship, how should one or both of the parties proceed? Following are some renegotiation principles after a deal has broken down:

1. *Resist the temptation to make belligerent or moralistic responses to a demand for renegotiation but seek to understand the basis of the demand.* A party facing a demand for extra-deal renegotiations often counters it with hostile, belligerent or moralistic objections. Such responses are hardly ever effective in persuading the other side to end its insistence on renegotiation since that party has already determined that its own vital interests require repudiation or renegotiation of the agreement. Normally, it is only by dealing with those interests that the two sides in a renegotiation can resolve the conflict. Moreover, the party asking for renegotiation almost always asserts equally moralistic arguments to justify it own demands: the contract is exploitative, the negotiators were corrupt, one side used duress, the other side was ignorant of all the underlying factors, or the basic circumstances of the deal have changed in a fundamental way.

While respect for agreements is indeed a norm in virtually all societies (and may even rise to the level of a universal principle of law), most cultures also provide relief, in varying degrees, from the binding force of a contract in a variety of circumstances. "A deal is a deal" (*pacta sunt servanda*) is certainly an expression of a fundamental rule of human relations, but so is the statement "things have changed" (*rebus sic stantibus*). While a request for extra-deal renegotiations may provoke bad feelings in one party, an outright refusal to renegotiate may also create ill will on the other side, which will see it as an attempt to impose an unjust bargain.

One may also argue that in many transactions (particularly between parties from different cultures) there are, in effect, two agreements: the legal contract, which sets out enforceable rights and duties, and the parties' "foundation relationship," which reflects their fundamental understanding in

all its dimensions, legal and nonlegal. An important, implied aspect of this relationship is an understanding, given the impossibility of predicting all future contingencies, that if problems develop in the future the two sides will engage in negotiations to adjust their relationship in a mutually beneficial way.

2. *Evaluate the benefits of a legal proceeding against the benefits of a future relationship.* The extent of a party's willingness to renegotiate an agreement will usually be in direct proportion to the value it attaches to its potential future relationship with the other side. If a party judges that relationship to be worth more than its claim for breach of contract, it will ordinarily be willing to engage in extra-deal renegotiation. On the other hand, if the party concludes that its claim is worth more than the benefits from a continuing relationship, it will usually insist on its contractual rights to the point of using litigation to protect them.

For example, one of the factors that encouraged Enron to renegotiate with the Maharashtra government after the cancellation of its electricity supply contract was the prospect of undertaking numerous energy projects throughout India in the years ahead. Enron clearly judged those potential relationships to be worth more than winning an arbitration award in a case that would certainly be a long protracted struggle. Looking forward, Enron therefore constantly remained open to renegotiation throughout its conflict with the State of Maharashtra.

Often an aggrieved party facing a demand for renegotiation cannot accurately evaluate the worth of its claim or the value of a renegotiated contract without first engaging in some kind of discussions with the other side. Moreover, satisfaction of its claim through litigation against the other side is almost always subject to long delays, a further inducement to enter into renegotiations. Indeed, one of the functions of the delays inherent in pursuing legal remedies is to give the parties an opportunity to negotiate an efficient solution to their conflict (Tracht 1999: 622).

3. *Look for ways to create value in the renegotiation.* A party facing a demand for renegotiation has a tendency to see the process as the worst kind of win-lose activity in which any advantage gained by the other side is an automatic loss to itself. As a result, an unwilling participant in an extra-deal renegotiation tends to be intransigent, to quibble over the smallest issues, to voice recriminations, and generally to fight a rearguard action throughout the process. By pursuing this approach, the parties may fail to capture the maximum gains possible from their encounter.

Joint problem-solving negotiation and integrative bargaining are as applicable to an extra- deal renegotiation as they are to the negotiation of the deal in first instance. The challenge for both sides in a renegotiation is to create an atmosphere in which problem solving can readily take place. Even if a party feels forced into an extra-deal renegotiation, it should approach the process as an opportunity to secure gains from the process. Thus, in the renegotiations between Enron and the Maharashtra State gov-

ernment over their electricity supply contract, while Maharashtra State gained a reduced power tariff, Enron secured the right to increase the capacity of its power plant.

4. *The parties should fully understand the alternatives to succeeding in the renegotiation — especially their costs.* The alternative to a successful extra-deal renegotiation in most cases is litigation in which the party seeking renegotiation will be the defendant and the party refusing it is the plaintiff. Litigation has risks and costs for both sides, and it is important that both sides understand them thoroughly as they approach the renegotiation process so they can accurately evaluate the worth of any proposal put forward.

Often the party demanding renegotiation has a tendency to undervalue the risks and costs of litigation while the party facing that demand tends to overvalue its benefits. It is therefore important for each side as part of its negotiating strategy to be sure that the other has a realistic evaluation of its BATNA.

Sometimes an aggrieved party may try to focus the other's attention on those costs by commencing a lawsuit while the renegotiation discussions are in progress. In the Enron case, at the time the Maharashtra government cancelled the electricity supply agreement, it probably assumed that its action would entail relatively little cost. It also seemed to have assumed that other investors would be willing to take Enron's place or that it would be able to find indigenous solutions to the state's power shortage. Once those assumptions proved false and once Enron had begun an arbitration case in London with a claim of $300 million, the State of Maharashtra became considerably more open to renegotiation than it was at the time it cancelled the contract.

5. *Involve, either directly or indirectly, all necessary parties in the renegotiation.* A successful renegotiation may not only require the participation of the parties who signed the original agreement, but it may also necessitate the involvement of other parties who did not sign it but who gained an interest in the transaction afterwards. Such secondary parties may include labor unions, creditors, suppliers, governmental departments, and in the case of diplomatic negotiations, other states.

For example, in the renegotiation of a loan between a bank and a troubled real estate developer with a partially completed office building, no new agreement can be reached without the participation, directly or indirectly, of the unpaid construction contractor whose lien on the property can block refinancing of the project. It is therefore important in organizing any renegotiation to determine all the parties, both primary and secondary, that should participate and then to decide whether they should be involved in the face-to-face renegotiations between the primary parties or dealt with in separate discussions.

6. *Design the right forum and process for the renegotiation.* Both sides should think hard about the appropriate process for launching and conducting extra-deal renegotiations. Renegotiations often emerge out of crisis characterized by severe conflict, threats, and high emotion. An appropriate process for the renegotiation may help to mollify the parties and reduce the negative consequences of the crisis on their subsequent discussions. An inappropriate process, on the other hand, may serve to heighten those negative consequences and impede the renegotiations.

The government of the State of Maharashtra, for example, after receiving the recommendation of a cabinet subcommittee, cancelled the contract with Enron and also declared publicly that it would not renegotiate the agreement. In that context, if renegotiations were ever to take place, the parties would need to create a process that would preserve the government's dignity and prestige. Ultimately, the government chose to appoint a "review panel" consisting of energy experts to reexamine the project. The panel met with Enron representatives, as well as project critics, and then submitted a proposal to the government, containing the terms of a renegotiated electricity supply agreement to which Enron had agreed. The use of a panel of experts to conduct what amounted to a renegotiation, rather than face-to-face discussions between the government and Enron, served to protect governmental dignity. Moreover, the panel's status as a group of independent experts, rather than politicians, tended to give its recommendations a legitimacy needed to persuade the public that the renegotiated agreement protected Indian interests.

In some cases, the way in which the parties frame the renegotiation may influence its success. For example, rather than use the label "renegotiation," a term that conjures up negative implications of fundamental changes in the sanctity of contract, the parties may refer to the process as a "review," "restructuring," "rescheduling," "modification," or an effort to clarify ambiguities in the existing agreement, rather than to change basic principles.[2] This approach, at least formally, respects the sanctity of contract and thereby may avoid some of the friction and hostility engendered by demanding outright extra-deal renegotiations. Yet another way of framing a renegotiation is a time-sensitive waiver, an approach that respects the agreement yet enables the burdened party to obtain temporary relief from certain contractual obligations.

7. *Involve the right mediator in the renegotiation process.* In the stress and hostility often engendered by an extra-deal renegotiation, a mediator or other neutral third person may be able to aid the parties to overcome the obstacles between them so as to reach a satisfactory renegotiated agreement. A mediator may make a positive contribution by helping design and manage the renegotiation process so that the parties will have the maximum opportunities to create value through their interaction; by assisting with the communications between the two sides in a way that will facilitate positive results from their interactions; and by suggesting

substantive solutions to the problems that the parties encounter during the course of their extra-deal renegotiation. To be effective, the mediator must have the blend of skills, experience, and confidence of the parties appropriate to the renegotiation in question. The wrong mediator, on the other hand, can make a difficult renegotiation impossible.

Concluding Thoughts

Many persons view a contract renegotiation in negative terms. For them, it is an aberration, a disreputable practice that evokes images of broken promises, disappointed expectations, and bargains made but not kept. From the viewpoint of anyone facing demands for an unwanted renegotiation, such a reaction is normal and understandable. But from the vantage of society, renegotiation plays a constructive role in human relations at all levels.

If Karl Llewellyn is correct — that the work of agreements in society is a struggle of life against form — the function of renegotiation in the social order is to mediate that struggle, to allow life and form to adjust to one another over the long term at least cost.

NOTES

1. Indeed, English common law at one time viewed renegotiated contracts under certain conditions as invalid since they lacked the legal requirement of consideration in those cases in which as a result of renegotiation a party was promising to do no more than it was already obligated to do under its original contract (Waddams 1999: 204).

2. In the economic slowdown of 2001, increasing numbers of borrowers in the United States have been unable to make regular mortgage payments on their homes. Instead of foreclosing on delinquent borrowers judged to have the potential to make payments at some point in the future, some banks have established "loan modification programs," by which they renegotiate the terms of the loan to prevent default (for example, by adding the unpaid interest to the principal of the loan). The banks frame these loans as "modified," not "renegotiated" mortgage agreements. See "Pinched homeowners are finding shelter in modified loans," *Wall Street Journal*, 30 October 2001, p. A1.

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