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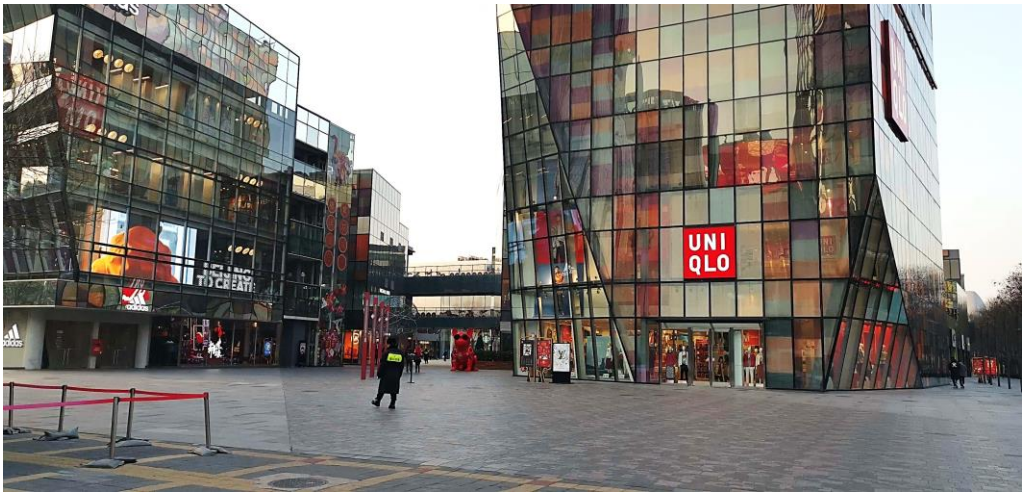
NEWSLETTER

THE IMPACT OF THE NEW CORONAVIRUS (COVID-19) ON CONTRACTUAL OBLIGATIONS: FORCE MAJEURE OR HARDSHIP?

The ongoing outbreak of the Covid-19 and the measures implemented to control the spread of the outbreak over the past three weeks have already prevented many enterprises and individuals from performing their contractual obligations. Suppliers have been prevented from delivering the promised goods. Clients have been prevented from taking the delivered goods. Contractors have been prevented from accessing construction sites. Retailers have seen their stores closed.

In the absence of agreed contractual provisions dealing with that particular situation, how to handle contracts affected by the current Covid-19 outbreak pursuant to the relevant PRC laws and regulations? Should the affected party claim the existence of a force majeure event as an excuse for the non-performance of its obligation or, instead, claim for a revision of the contract on the ground of unforeseen hardship?



editorial

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Like in most of the civil, common and international legal systems, under PRC laws, *pacta sunt servanda-agreements must be kept*. The traditional excuse to the performance by a party to a contract of its contractual obligations without being deemed in breach of the contract is when such performance is impossible for an event of force majeure. Article 117 of the PRC Contract Law provides indeed that: "*if the contract cannot be performed due to an event of force majeure, liability is partially or wholly exempted depending on the effect of the event of force majeure, unless the law provides otherwise*".

Pacta sunt servanda
agreements must be kept

However under PRC laws, it is admitted that hardship provides, under certain circumstances, an additional ground for the discharge of the contract or for its adaptation to the changed circumstances.

This has been legally recognized under the *Interpretation of the Supreme Court on Certain Issues Concerning the Application of the PRC Contract Law (II),* issued by the Supreme People's Court in 2009, which provides the following: "*Where a party to a contract petitions the court to modify or terminate the contract on the grounds that the continuous performance of the same is obviously unfair to the party or the purpose of the contract will not be realized due to occurrence of any material change of circumstances that is unforeseeable, not caused by force majeure, and not a commercial risk after the conclusion of the contract, the court shall decide whether the contract shall be modified or terminated according to the principle of fairness on a case-by-case basis.*"

An illustration of the above principles can be found in the judicial practice that followed the SARS outbreak in 2003, which is of the same nature as the Covid-19 and had similar adverse effects on business activities in China. In that respect, the Supreme People's Court issued a notice (Fa [2003] No. 72) specifying that contracts affected by the SARS outbreak shall be dealt with either (i) on the ground of force majeure, or (ii) or the ground of hardship. Accordingly, in judicial cases relating to contracts affected by the SARS outbreak, some courts defined SARS as force majeure event while some others as hardship (change of circumstances) depending on the circumstances of the cases. The judicial practice in relation to contracts affected by the Covid-19 is likely to follow the same path.

FORCE MAJEURE

Would the Covid-19 outbreak qualify as a force majeure event under PRC laws?

Under the PRC Contract Law, force majeure is defined as "*objective circumstances which cannot be foreseen, avoided and overcome*" (Article 117 of the PRC Contract Law).

Theoretically, the outbreak of the Covid-19 may not necessarily be seen as an unforeseeable event given the outbreaks of various strains of epidemic in recent years (SARS, Ebola, Bird flu…). However, it can be, in our opinion, reasonably argued that the unprecedented scale of the restrictions enforced by the PRC authorities over the past three weeks, which include closure of Wuhan City and Hubei Province, extension of the Chinese New Year holiday and further restrictions enacted at provincial or city levels, could not be foreseen by the parties at the time of the execution of the contracts and, further, that the Covid-19 outbreak together with the restrictions enforced cannot be avoided and overcome.

It is worth noting that on February the 10th, the spokesman of the Legislative Affairs Commission of National People's Congress Standing Committee, answering to a public inquiry about contracts affected by the Covid-19 epidemic and related measures, issued a statement confirming that for those contracts that cannot be performed as a consequence of the Covid-19 epidemic and the measures enforced to prevent and control the spread of the Covid-19 epidemic, the affected party could claim the occurrence of a force majeure event which could not be foreseen, avoided and overcome. Although this statement has no legal effect, this opinion is likely to be followed by courts which may have to decide on whether the Covid-19 epidemic shall constitute a force majeure event under PRC laws.

The Covid-19 outbreak is likely to qualify as a force majeure event

Would the Covid-19 outbreak validly exempt the affected party from its contractual liability?

The qualification of the Covid-19 epidemic as a force majeure event under PRC laws is obviously not sufficient to exempt a party from its contractual liability. The performance of the contract has to be impossible as the result of the Covid-19 epidemic and related measures enforced. If the contract is merely affected by the force majeure event but can still be performed in a way or another, force majeure would not be a valid excuse for not performing contractual obligations.

The above referred notice issued by the Supreme People's Court in 2003 in relation with the SARS epidemic states clearly that force majeure shall apply only when a party is not able to perform the contract "*as a direct result of the administrative measures taken by the government or relevant authorities in order to control SARS*", or if there is a "*fundamental impossibility of performance*" due to the SARS outbreak and related measures. PRC courts have strictly apply those principles. For instance in a case ruled by the Henan Province Kaifeng Municipal Intermediate People's Court ((2010) Bian Min Zhong Zi No. 1073/(2010)汴民终字第 1073 号), the court ruled that "*the SARS does not affect the performance of all kinds of contracts, and if it does not affect the normal performance of certain contract, it shall not be deemed to be force majeure (in this particular case)*". Typically, rental contract, loan contracts and more generally contracts containing payment obligations are generally not deemed to be affected by a force majeure event such as an epidemic outbreak, and this, notwithstanding the fact that the underlying business may have been adversely impacted.

Considering the above, a party to a contract who is willing to claim the occurrence of the force majeure event, shall carefully collect all evidences, notably all the measures enacted and enforced locally in connection with the Covid-19 epidemic and the consequences of those measures on the performance of its contractual obligation. In that respect, one may note that provinces and cities in PRC have issued many different rules and policies over the past few days. The impact of the measures enacted in relation with the Covid-19 on contracts may thus vary from a location to another. Obviously, in Wuhan city and Hubei province, where the most strict administrative measures are in force for the time being, performance of relevant contracts shall be heavily impacted. The situation could be different in other cities and provinces which have enacted less strict measures for companies and individuals located in those jurisdictions. A case by case analysis shall be undertaken.

Last but not least, as provided under the PRC Contract Law (Article 118), any party willing to claim force majeure shall give a notice to the other party in a timely manner so as to mitigate the losses that may be caused to the other party. Such a notice should, in our opinion, describe the event that occurred and the scope of obligations the performance of which is rendered impossible (with reasonable details and, if available, evidences) as well as the measures implemented or proposed by the affected party in connection within the performance of the contract. This procedural step shall not be neglected as the affected party shall only be exempted from its liabilities under the contract to the extent that it has taken appropriate measures, if available, to mitigate the losses that the other party may suffer as the result of the force majeure event.

Only impossible performance timely notified can be claimed as the result of force majeure

Would the force majeure event allow a party to termination the contract?

A force majeure event can validly be an excuse to the non-performance by the affected party of its contractual obligation and thus a defense in an action for damages that would be taken by the other party. Nevertheless, article 94 of the PRC Contract Law also provides that a party may terminate a contract if "*an event of force majeure makes the objective of the contract unachievable*".

The parties to a contract the performance of which is currently impossible for the reasons of the Covid-19 and related measures enforced, may be willing to terminate that contract as permitted under PRC laws. Indeed, a client who is prevented from taking delivery of goods might be willing to cancel the agreed purchase of goods, which might be of little use considering the current slow-down of its activities for the reasons of the Covid-19 outbreak. Yet, its supplier might also be willing to cancel the agreed delivery so that it can be free to sell the promised goods to another client who can take the delivery and thus mitigate its losses. This question is particularly relevant considering that the current situation where no one knows how long the Covid-19 outbreak will last and how much business activities will be impacted.

The issue, here, is not only, to understand how to interpret the condition that gives the right to a party to terminate the contract in case of force majeure event: the purpose of the contract cannot be achieved; but also whether the non-affected party is entitled to terminate the contract should the force majeure and impossibility to perform be temporary and thus the affected party will be in the position to perform in full the contract when the impossibility ceases.

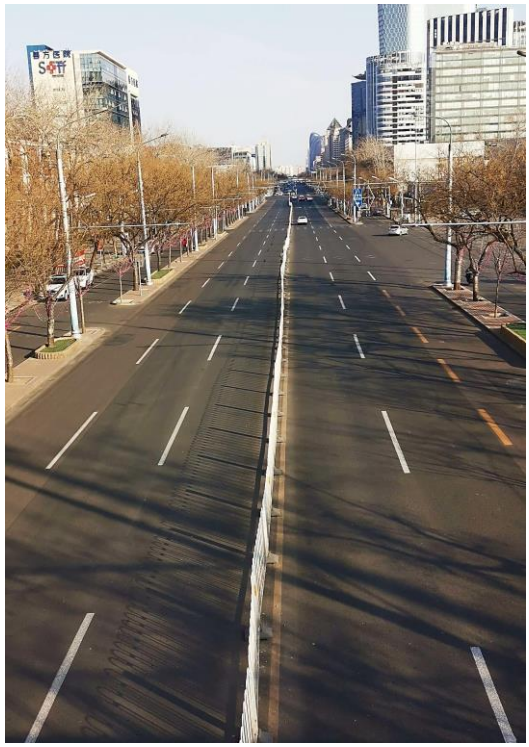
On the first question, PRC courts have already given some answers. For instance, in a case ruled by Liaoning Province Higher People's Court ((2013) Liao Shen Er Min Kang Zi No. 14 / (2013) 辽审二民抗字第 14 号), the court ruled that the SARS outbreak only caused part of the business operation impossible to be carried out, and accordingly the rental contract can still be performed and shall not be terminated due to force majeure. Furthermore, it is worth noting that several PRC courts have already issued some opinions on how to deal with Covid-19 potential related cases. For instance, On February the 10th, the Higher People's Court of Zhejiang Province issued a notice, *Implementation Opinions on Civil Legal Disputes Relating to NCP Epidemic Situation* (for trial implementation) to the attention of, and as a guidance, all PRC courts in Zhejiang Province with respect to labor disputes, contract disputes and tort disputes. With regard contract disputes, this notice sets forth, among others, that if the contract can continue to be performed amid the Covid-19 epidemic, the courts shall encourage the continuous performance and any petition for the termination of contract should not be upheld.

The PRC Contract Law is silent on the second question. Contractual provisions relating to force majeure normally deal with that second question by providing that if the impossibility lasts beyond a certain period of time, then either party may terminate the contract. In other words, it is common practice that in case of force majeure, the affected party will be given an extension of time for performance until the impossibility ceases. Only if the impossibility lasts too long, termination of the contract could be considered. To our knowledge, PRC courts have not ruled on that principles. Nevertheless, considering that PRC courts have indicated that they will favor continuation of contract notwithstanding the Covid-19 outbreak, it is likely that PRC courts will not support termination of contracts as the result of the Covid-19 epidemic. Then, when the delay will make the performance substantially more burdensome for a party, the rules on hardship must be consulted.

PRC courts will not likely support termination of contracts for force majeure

HARDSHIP

The PRC laws do provide that hardship is a ground for the discharge of the contract or for its adaptation to the changed circumstances.



The first key feature of the hardship principle under PRC laws is the foreseeability. As is the case with force majeure claim, the general principle is that the event shall not have been foreseeable at the time of the conclusion of the contract. In other words, any commercial risks or risks that can be foreseen by reasonable parties at the time of the conclusion of the contract, taking into account the object of the contract, shall not be considered as a ground for an adaptation to the changed circumstances. Regarding the Covid-19 outbreak, as discussed above for force majeure, while it could be argued that an epidemic outbreak can be foreseeable, the unprecedented scale of the restrictions enforced by the PRC authorities over the past three weeks could not have been foreseen by the parties at the time of the conclusion of the contract and, consequently, the Covid-19 outbreak and related measures satisfies, in our opinion, the unforeseeability criteria.

The second key feature of the hardship principle under PRC laws is that whether or not the equilibrium of a contract has been fundamentally altered by an event that could not be foreseen by the parties, is under the control and discretion of PRC courts. PRC laws do not define criteria to assess the "*obvious unfairness*" that may ground the application of hardship. One may note that PRC courts have been consistently prudent in supporting changes to a contract for the reasons of hardship. Nevertheless, the particular circumstances of the Covid-19 outbreak may be better supported by the PRC courts for the following reasons.

First, looking at PRC court decisions with respect to the SARS outbreak, hardship has been frequently used in cases relating to rental payment. For instance, in the case ruled by the Shanghai Second Intermediate People's court ((2004) Hu Er Zhong Min Er (Min) Zhong Zi No. 354 / (2004) 沪二中民二(民)终字第 354 号), based on the equitable principle, three-month rent was exempted considering that the applicant who was engaged in entertainment closed its business operation during the SARS period in response to the governmental requirement.

Second, in the recent opinions issued by PRC courts on how to deal with Covid-19 potential related cases, PRC courts have expressly indicated that hardship shall be considered in connection with the Covid-19 outbreak in order to favor the continuation of contracts. For instance, this general principle is expressly stated in the opinion issued by the Higher People's Court of Zhejiang Province referred above, which notably provides the example of tenancy agreement, for which if the property cannot be used temporarily due to the Covid-19 prevention and control measures, and if such situation is not attributable to the landlord or the tenant, then

at the request of the tenant and based on fairness, tenancy term can be extended, rentals can be reduced or exempted, and consequently any petition for the termination of contract by the tenant should not be upheld.

Third, one may note that local government have already issued a certain number of enforceable policies in order to address the consequences of the Covid-19 outbreak. For instance, on February the 8th, the Shanghai Government issued *Several Policies and Measures to Make All-out Effort in Preventing and Controlling Epidemic and Supporting and Providing Service for Steady and Healthy Development of Enterprises*, providing 28 comprehensive policies and measures. Those 28 policies include a certain number of tax and financial incentives but also, a two-month exemption of rental (for February and March) for those small-and-medium-sized enterprises who rent stated-owned properties for production or commercial activities. Obviously, the Shanghai Government has no power to impose exemption of rental for privately-owned properties by it encourages large business buildings, shopping malls etc. to reduce or exempt rentals for their tenants; and for those who voluntarily agreed to reduce or exempt rentals for their tenants, and who have difficulties in paying property tax or urban land use tax, reduction or exemption of the same will be proposed.

Similarly, the Suzhou Government has issued *Ten Policy Opinions on Handling Pneumonia Diseases Caused by Novel Coronavirus Infection to Support SMEs to Tide over Difficulties Together*, which provides similar measures and encouragement than the policies issued by the Shanghai Government. So it is the case in many other cities or provinces.

In our opinion, the above is likely to help a party seeking an adaptation of contracts for the reasons of the Covid-19 outbreak and related measures, to amicably negotiate such changes but also to ground a claim for hardship before PRC courts if the negotiations failed.

Claim on the ground of hardship can be considered

FORCE MAJEURE AND HARDSHIP IN INTERNATIONAL TRADE

Most of the international trade agreements contain force majeure clauses. Those clauses generally provide an excuse to the affected party for the non-performance of the contract and further the suspension of the parties' obligations throughout the duration of the force majeure event and if the force majeure event continues beyond a certain period of time, the right of the parties to terminate the contract. Similarly to the model clause on force majeure published in 2003 by the International Chamber of Commerce (ICC), some of those clauses may further list the events, which may specifically include epidemic and thus be deemed an event meeting the typical features of force majeure, i.e.: an event beyond the control of the affected party that could not be foreseeable at the time of the conclusion of the contract.

In the absence of contractual provisions regarding force majeure, the parties will have to rely on the relevant provisions of the law governing the contracts (including, if applicable, international conventions such as the United Nations Convention on Contracts for the International Sale of Goods - CISG -, also known as the Vienna Convention) that may vary from a jurisdiction to another with respect to both the definition of force majeure or impediment and the available rights and remedies in case of force majeure or impediment.

Usually in all legal system and international conventions, the affected party will have to evidence that: (i) the Covid-19 outbreak falls within the relevant definition of force majeure or impediment, (ii) the Covid-19 has materially impacted or rendered impossible its performance of the contract, (ii) it has duly and timely notify the other party of the occurrence of the event and (iv) it has taken all reasonable steps to avoid or mitigate the consequences of the Covid-19.

The affected party will thus have to collect and compile as much evidences as possible on the measures enforced by the Chinese authorities (such as travel restrictions, quarantines, extension of the Spring Festival holiday as enforced locally in China) and on the effects of the Covid-19 outbreak on the performance of its contractual obligations. If the affected party is based in China, it may also consider applying for a "*force majeure certificate*" to be issued by the China Council for the Promotion of International Trade (CCPIT) or other institutions such as Chambers of Commerce. One may note that the first force majeure certificates have already been issued by the CCPIT for the reasons of the Covid-19 outbreak at the request of Chinese-based parties in connection with their business with overseas parties. A force majeure certificate issued by the CCPIT may indeed assist the affected party to preliminary evidence that a force majeure event has occurred in connection with the Covid-19 outbreak. However, except if the contract expressly provides for the delivery of such kind of certificate as undisputable evidence (which is rare in practice), the affected party cannot rely only on a force majeure certificate issued by the CCPIT or other institutions and the other party remains free to challenge the occurrence of the purported force majeure event based on the agreed contractual provisions or relevant applicable laws.

Contrary to force majeure, usually only few international trade agreements contain hardship clauses. Except for long-term agreements for which it is not possible to deal, at the time of the negotiations and execution of the contract, with all potential changed circumstances over the term of the contract, parties to international trade agreements are generally reluctant to include hardship clauses. Hardship clauses typically providing for (i) the right of a party to request the negotiations of alternative contractual terms should the continued performance of its contractual obligations has become excessively onerous due to an event, which could not be foreseen at the time of the execution of the contract and which cannot be avoided and overcome, and (ii) the right of such party to terminate the contract if the negotiations fail (for an example, see the model clause on hardship published in 2003 by the ICC).

Potential claims for hardship in connection with the Covid-19 shall then be assessed pursuant to the relevant laws governing the contract. In that respect, one may note that, similarly to China, many continental legal systems, among them Germany, the Netherlands, Italy, Greece, Portugal as well as Scandinavian countries, accept the theory of hardship while common laws legal system are reluctant to accept changed of circumstances that do not amount to impossibility or fundamental frustration. International legal systems, such as the CISG, seems to follow that second doctrine of impossible or fundamental frustration.

Nevertheless, in all legal systems and relevant judicial practice, hardship has never not been widely applied. Consequently, and contrary to what may happen in China with respect to adapting the contract to the changed circumstances, it is no likely that the Covid-19 outbreak would ground revisions to, and potentially termination of, international trade agreement for hardship. Affected parties are more likely to successfully claim force majeure. This will however need to be further assessed on case by case basis taking into account practice of relevant domestic courts and circumstances of the case.

For international trade agreements, affected parties are more likely to successfully claim force majeure than hardship

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