THE UNIVERSITY OF MELBOURNE

Asian Legal Conversations — COVID-19

Asian Law Centre
Melbourne Law School

The Contractual Impact of COVID-19 - Common Law and Chinese Law

Andrew Godwin*

During the course of the COVID-19 pandemic, the social isolation measures, the closure of borders and the restrictions on business activity (including the provision of goods and services in the ordinary course of business) have seriously disrupted private contractual arrangements between commercial parties on both a domestic and cross-border basis.

As in other crises, such as the Global Financial Crisis of 2007-2008, contracting parties inevitably focus their attention on the terms of commercial contracts and their respective rights and liabilities. In terms of rights, the relevant questions include whether they have the right to terminate contracts or to take steps to protect their financial and commercial interests. In terms of liabilities, the relevant questions include whether they will be liable for any delay or failure in the performance of contractual obligations, and what steps they can or should take to mitigate any losses that might be incurred.

This note examines the contractual impact of pandemics on corporate and financial transactions in three areas: material adverse change clauses, *force majeure* clauses and the doctrine of frustration. The focus is on the treatment of these areas in common law jurisdictions, but the note also makes comparative reference to the position in other jurisdictions, particularly mainland China.

MATERIAL ADVERSE CHANGE CLAUSES

A key purpose of commercial contracts is to allocate risk between the parties and to identify what consequence should arise if any commercial or financial risks increase as a result of a change in circumstances or the occurrence of an adverse event after the contract was signed. Often the change in circumstances or the adverse event was not foreseeable by the parties on the date on which the contract was signed.

In general terms, a material adverse change (MAC) clause[1] allows one party to exercise certain rights in the event that a material adverse change occurs. The clause might trigger the right of the relevant party to terminate a contract or to choose not to perform, or continue to perform, its obligations under a contract. As a result of its potential impact, a MAC clause is often heavily negotiated between the parties and their lawyers.

MAC clauses are common in the context of loan agreements, where a material adverse change that affects the ability of the borrower to perform its obligations allows the lender to refuse to advance funds to the borrower or to accelerate the loan and demand repayment of all of the funds that have already been lent. In addition to loan agreements, MAC clauses sometimes appear in underwriting agreements and acquisition agreements. In the context of an acquisition agreement, the MAC clause can operate as a condition precedent to completion, under which the failure to satisfy the condition by the completion date allows the purchaser to terminate the acquisition agreement and to withdraw from the transaction.

In common law jurisdictions, a MAC clause will be interpreted in accordance with the general principles of contract law; namely, the courts will ascertain the intention of the parties primarily by reference to the words that the parties have used to draft the clause. As a result, the drafting of a MAC clause is of critical importance as it will determine when the clause can be triggered. If the agreement was entered into after the onset of a pandemic, it will be more

* Associate Director (Asian Commercial Law), Asian Law Centre, Melbourne Law School.

1 MAC clauses are also known as material adverse effect clauses.

difficult to trigger the MAC clause as it could be argued that the impact was foreseeable on the date of the agreement. In addition, it will be a question of proof as to whether the pandemic-related event has resulted in a material adverse change as defined by the MAC clause. Proving the likelihood that the event will have a material adverse change will be complicated by uncertainties about the duration of the pandemic and its impact and other relevant factors, such as the availability of government measures (including grants and loans) to assist businesses to recover from the effects of the pandemic.

In mainland China, a MAC clause in a contract that is governed by PRC law will be interpreted in accordance with the provisions of the *Contract Law*. As a result of the general principles of fairness and good faith, which appear in Articles 5 and 6 respectively, it is possible that such a clause will be interpreted more restrictively than in the case of contracts governed by the laws of a common law jurisdiction.

FORCE MAJEURE CLAUSES

In general, *force majeure* refers to an unforeseen event that is outside the control of the parties to a contract and prevents or delays the performance of obligations by one or more of the parties. Two questions are of fundamental importance in understanding how the concept works: (1) what is the definition of '*force majeure*'; and (2) what are the legal consequences of *force majeure*?

The law in England and other common law jurisdictions does not provide a statutory definition of the concept of *force majeure*. Unlike the position in other jurisdictions, it is not a term of art with a legislative definition. Instead, the concept is incorporated into contracts by the parties based on their own free will and is therefore subject to the principles of contractual interpretation. These principles include the rule known as the *contra proferentem* rule; namely, the rule that a clause excluding the liability of a party to the contract should be interpreted narrowly. Further, if the clause is ambiguous, it should be interpreted against the interests of the party who is seeking to rely on it. In addition, the burden of proving that an event of *force majeure* has occurred is on the party that is seeking to rely on it.

Because the concept is not governed by written law but instead by the contractual terms between the parties, the relevant clause often lists the events that qualify as events of *force majeure*. These may include the following events: (1) an Act of God such as a natural disaster; (2) laws and changes in law that prevent the performance of obligations; (3) war and civil disturbance; (4) epidemics; and (5) strikes.

The legal consequences of a *force majeure* clause will depend on how the clause is drafted. For example, the clause may suspend the performance of obligations by the affected party for the period that the event of *force majeure* continues. Alternatively, or in addition, the clause may provide that one or both of the parties have the right to terminate the contract after a certain period of time. In general, the clause will provide that the affected party has an obligation to notify the other party and to mitigate the effects of the *force majeure*.

Similar to the position with a MAC clause as discussed above, a determination of whether a *force majeure* event has delayed or prevented performance as a result of a pandemic-related event may be complicated by uncertainties about the duration of the pandemic and other relevant factors, such as government measures (including grants and loans) to assist businesses to recover from the effects of the pandemic.

Mainland China has adopted the approach of civil law jurisdictions in terms of including the concept of *force majeure* in its written law. The main laws in which the concept appears are the Contract Law (Articles 117 and 118), the General Principles of Civil Law (Articles 107, 139 and 153) and the General Provisions of Civil Law (Articles 180 and 194). It is important to note that unlike the position in common law jurisdictions, where the parties are free to include or exclude *force majeure* clauses in the contract, the *force majeure* provisions in Chinese law are considered to have mandatory application; namely, the provisions apply irrespective of whether the parties have included relevant clauses in the contract. In addition, the parties cannot choose to limit or exclude the provisions by contract, although it is possible to broaden their scope in the contract.

In some countries, government authorities issue companies with *force majeure* certificates in circumstances where an event has occurred that has a broad impact (i.e. an impact beyond an individual company). These do not have any legal effect under contracts governed by the law of common law jurisdictions, except where the *force majeure* clause is expressly triggered by the issue of such a certificate. They are, however, likely to have probative force in countries where *force majeure* has a legislative basis. The China Council for the Promotion of International Trade (CCPIT) announced on 30 January 2020 that it would offer *force majeure* certificates to help companies deal with disputes with foreign trading partners arising from epidemic control measures.[2]

2 China Council for the Promotion of International Trade, 'CCPIT Commercial Certification Center Provides *Force majeure* Certificates of Novel Coronavirus Pneumonia Service' (Statement dated 21 February 2020), available at http://en.ccpit.org/info/info_40288117668b3d9b0170671f67f30716.html.

FRUSTRATION

Under the doctrine of frustration in common law jurisdictions, a contract will automatically be terminated if an event occurs that so fundamentally affects or prevents the performance of the contract that it would be unjust to require the parties to perform their obligations.

It is important to be aware of the difference between *force majeure* and the doctrine of frustration. Frustration is much narrower and refers to the situation where an event occurs that renders it physically or commercially impossible to perform the contract or changes the obligation into a radically different obligation from that undertaken by the relevant party at the time the contract was entered into. The consequence of frustration is that the affected obligations are discharged. Because of the uncertainty concerning the circumstances in which frustration applies, the parties to a contract usually prefer to include a *force majeure* clause in the contract rather than to rely on the common law doctrine of frustration. Where express provision has been made in the *force majeure* clause for the event that has occurred, the contract will not be frustrated. Further, the wider the scope of the *force majeure* clause, the narrower the scope for frustration to be argued.

An event will not be held to be a frustrating event if it was foreseeable or in the contemplation of parties when they entered into the contract. In the light of the 2003 SARS-CoV, the 2015 MERS-CoV and the 2014–15 Ebola virus outbreaks, it might be argued that a pandemic is no longer an unforeseeable event. That said, it may be possible for parties in the context of the current COVID-19 pandemic to argue frustration on the basis that the scale of the pandemic and the severity of the public health response could not have been foreseen.

In some jurisdictions, the doctrine of hardship provides a basis for permitting a party to request that a contract be renegotiated or, failing agreement with the other party, to request a court to terminate or modify the contract. Some, but not all, civil law jurisdictions recognise this principle in their domestic law. For example, it is recognised by Germany, Italy and the Netherlands. However, it is not recognised in France.

In mainland China, the Supreme People's Court recognises that a change of circumstance may lead to a contract being amended or terminated, even in the absence of an express contractual provision to this effect. This is provided by Article 26 of the Supreme People's Court Interpretation on Several Issues Concerning the Application of the PRC Contract Law (2), which came into effect on 13 May 2009. This provision is largely based on Article 6.2.2 of the *UNIDROIT Principles of International Commercial Contracts, which deals with the doctrine of hardship*.[3]

There is an important difference between the doctrine of hardship and the doctrine of frustration as recognised in common law jurisdictions. Under the doctrine of hardship as reflected in the UNIDROIT Principles, a court has the power to modify a contract if it would be reasonable to do so. Under the doctrine of frustration, on the other hand, the court only has the power to declare that a contract has come to an end.

CONCLUSION

This note has provided a high-level overview of the contractual impact of pandemics on corporate and financial transactions in three areas: material adverse change clauses, *force majeure* clauses and the doctrine of frustration. The discussion highlights both the complexities of these concepts and also the extent to which their operation is subject to the specific circumstances, even in the context of the COVID-19 pandemic.

3 UNIDROIT Principles of International Commercial Contracts 2016, available at https://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2016.