

**Coronavirus:**  
Legal implications and practical  
considerations  
to protect your business interests  
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Freshfields Bruckhaus Deringer

## Coronavirus:

Legal and practical considerations to protect your business interests

# Introduction

The effects of the novel coronavirus outbreak have been widespread and continuing. Aside from the obvious impact on the airline and tourism industries, we are seeing a knock-on impact on sectors as diverse as automotives, manufacturing, finance, technology, construction, energy, insurance and commodities.

Global supply chains have been disrupted by factory closures in China, especially in Wuhan, a manufacturing hub for electronics and cars – creating production bottlenecks and inventory issues down the line. Travel and port restrictions are limiting the flow of workers, engineers and goods, with an impact on infrastructure and construction projects, and deliveries of supplies, both in China and beyond. The sharp decline in consumer spending in China and other parts of Asia – as people avoid public places – also threatens to impose cashflow pressure on businesses. Demand for energy has dropped, leading to falling oil prices and overcapacity concerns. These and other issues are likely to continue to cascade and ripple through the highly inter-connected global economy.

An issue we are increasingly advising clients on is the extent to which the outbreak excuses them or their counterparties from their contractual obligations. This briefing provides general guidance on this issue.

# Executive summary

The coronavirus outbreak is having a significant impact on commercial dealings, which are increasingly interconnected. Whether a party is excused from its obligations requires a holistic consideration of contractual provisions (eg force majeure, MAC and change of law clauses), and applicable laws in multiple jurisdictions (eg legal frustration, force majeure and change of circumstances).

The precise contours of these legal provisions and principles, and the interplay between laws which are potentially in conflict, is not straightforward, as explained in this briefing.

With the rapidly developing situation, it is important to closely monitor the outbreak and how it may affect performance of contractual obligations. Some practical steps that may be taken include the following:

- If performance may be affected, take reasonable steps to work around these risks or discuss them with your counterparty. Where you can perform some but not all of your contracts, be very careful about which contracts you prioritise, bearing in mind applicable laws and relevant contractual provisions.
- If your supply chain is exposed to the effects of the outbreak, line up fallback options.
- Consider whether your insurance policies cover the outbreak or its knock-on effects.
- Be aware of notice requirements which are preconditions to force majeure provisions and insurance protection.
- Keep a detailed record of how the coronavirus outbreak and its knock-on effects are impacting your performance – this is useful in a later dispute over liability. For the same reason, be circumspect in how you refer to the effects of the outbreak in discussions and internal or external communications.
- Consider the longer-term relationship with your counterparties, and whether force majeure, frustration or the other principles discussed in this briefing can be used as leverage to negotiate a sensible commercial solution to the difficulties caused by the current outbreak.
- Consider other commercial and reputational risks that may arise from the outbreak, including HR/employment issues and the risk of counterparties becoming insolvent.

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# What does your contract say?

A good first step is to consider the terms of your contract, as construed under the applicable governing law.

### | *Force majeure clauses*

Commercial contracts often contain ‘force majeure’ clauses, which excuse a party from performing in certain circumstances or may even allow for termination of the contract without liability. A typical force majeure clause may provide that a party is excused where it is prevented (or hindered or delayed) from performing their obligations due to:

‘acts of God, flood, drought, natural disaster, war, or any other cause beyond the control of [that party]’.<sup>1</sup>

In general, a party directly affected by the coronavirus outbreak would have to show that the outbreak falls within the scope of the force majeure clause, as construed under the governing law of the contract. Key considerations include whether:

- the clause expressly states that an epidemic, pandemic or contagious disease would constitute a force majeure event. This is particularly relevant in light of the World Health Organisation’s declaration that the coronavirus outbreak is a ‘Public Health Emergency of International Concern’;<sup>2</sup>
- the coronavirus outbreak has resulted in events that are expressly stipulated in the clause, such as shortage of labour or raw materials or strikes; and
- the clause contains general language (such as references to ‘any cause beyond the control of the party’) and – importantly – whether these can be construed under the governing law as including the coronavirus outbreak or the effects of the outbreak.

Many force majeure clauses do not expressly identify epidemics, pandemics or contagious diseases as force majeure events. In such cases, it will be necessary to analyse whether the follow-on effects of the coronavirus outbreak fall within the scope of the force majeure clause, or whether it is worded broadly enough to encompass events of a comparable nature to those identified in the clause. The governing law of the contract may also prescribe relevant principles of contractual interpretation, such as a preference for the interpretation that conforms to business common sense, or the *eiusdem generis* rule.

Significantly, PRC law contains a free-standing legal doctrine of ‘force majeure’ (不可抗力), which may apply even if the contract in question does not contain a force majeure clause. This is discussed below.

1. See also the ICC force majeure clause 2003, which includes ‘epidemic’ in its list of events that would be presumed to have established a force majeure event (<https://iccwbo.Org/publication/icc-force-majeure-clause-2003icc-hardship-clause-2003/>).

2. [https://www.Who.Int/news-room/detail/30-01-2020-statement-on-the-second-meeting-of-the-international-health-regulations-\(2005\)-emergency-committee-regarding-the-outbreak-of-novel-coronavirus-\(2019-ncov\)](https://www.Who.Int/news-room/detail/30-01-2020-statement-on-the-second-meeting-of-the-international-health-regulations-(2005)-emergency-committee-regarding-the-outbreak-of-novel-coronavirus-(2019-ncov))

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#### | **Material adverse change clauses**

Lending and M&A contracts often contain material adverse change clauses (MAC clauses). Such clauses allow banks in lending transactions to call a default if there is an adverse change in the borrower's position or circumstances; and allow buyers in M&A transactions to walk away from the acquisition before closing if events occur that are detrimental to the target company. For example, a facility agreement may allow a lender to call a default if there is a 'material adverse change in the borrower's ability to perform its obligations under the finance documents', and/or in the 'business, operations, property, financial condition or prospects' of the borrower.

Whether the coronavirus outbreak has triggered the MAC clause in your contract will involve similar considerations as those set out above, including the precise words used in the clause (eg, references to operational disruptions or financial prospects), and how the clause is construed under the governing law of the contract. MAC clauses are often heavily negotiated and may be worded in broader or narrower terms depending on the parties' bargaining power – thus, they need to be analysed on a case-by-case basis.

#### | **Change of law clauses**

Certain contracts – such as long-term contracts – may also contain 'change of law' clauses, which entitle either party to terminate the contract and/or use best efforts to re-negotiate terms where a change in the law makes it impracticable or impossible for a party to perform its obligations under the contract.

Such clauses could become relevant if the coronavirus outbreak leads to laws being passed that, in an attempt to curb the outbreak, restrict a party's ability to perform its contractual obligations. These may include travel restrictions, quarantine measures, government-mandated factory closures or supply chain blockages.

Parties to China-related contracts should therefore keep a close eye on any new legislative and administrative measures passed by the PRC legislature and other organs of the PRC government in response to the outbreak. They should also monitor judicial interpretations issued by the Supreme People's Court, as these interpretations will guide lower courts in how they approach cases involving the outbreak. Whether such legislative, administrative or judicial measures can give rise to remedies under 'change of law' clauses will depend on, among others, the scope and precise terms of the relevant clause.

## Are you excused under applicable law(s)?

Apart from the contractual provisions, many legal systems also contain general principles which excuse parties from strict compliance with obligations where it is impossible (or possibly, difficult) to do so. These provisions apply even if the parties' contracts do not expressly provide for such a right and for this reason, they are also potentially significant.

#### | **Frustration**

Most common law systems, including Hong Kong and English law, provide that a contract may be discharged for frustration, where something occurs after the formation of the contract that makes it physically or commercially impossible to fulfil the contract, or transforms the obligation to perform into a radically different obligation.

Significantly, the threshold for establishing frustration is high, and where there is a broadly drafted force majeure clause or one which captures the present situation, parties may be better off relying on such a clause. The frustrating event:

- must not be an event anticipated or provided for in the contract;
- must not be caused by the party seeking to rely on it; and
- must be an outside event or extraneous change of situation.

In the present situation, disputes may arise over whether the disruptions make performance impossible, or a radically different obligation, or if they merely form part of the risks that the parties had agreed to allocate under the contract. Much will turn upon the length and intensity of the events in question, and whether these can be overcome with time, or not.

For example, a contract for the supply of goods may be frustrated if the extended holiday or travel restrictions have rendered it impossible for the supplier to deliver the goods by a certain date and where time is of the essence.

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#### | *Frustration (continued)*

Conversely, there is no frustration if the disruption is relatively more limited. For example, during the 2003 SARS outbreak, a Hong Kong court rejected a tenant's claim that an isolation order preventing the tenant from occupying certain leased premises had frustrated the lease agreement. The court found that the tenant had been prevented from occupying the premises for about 10 days, and that did not significantly change the nature of the tenant's rights under the lease agreement, which was for a 2-year term.<sup>3</sup>

#### | *'Force majeure' under PRC law*

Much of the impact of the coronavirus outbreak is currently being felt in mainland China, and accordingly, PRC law will be relevant to questions of contractual liability.

Significantly, PRC law has a number of provisions which will be unfamiliar to common law lawyers, but which are potentially of great importance.

In international transactions resolved outside mainland China, interesting questions will arise as to the extent to which PRC law will be determinative on questions of liability, where the underlying commercial relationships are also subject to other laws. This is an area where our clients are already encountering challenging questions, and we foresee that this will remain a controversial issue in the future.

PRC law recognises a doctrine of force majeure which applies even if the underlying contract does not contain a force majeure clause. Under this doctrine, a party is excused from civil liability if it fails to perform a contract or causes loss or damage to other parties due to force majeure (不可抗力), which is defined to mean objective circumstances that are unforeseeable, unavoidable and insurmountable; in such circumstances, a party may also be entitled to terminate the contract or be exempted partly or wholly from non-performance.<sup>4</sup>

To rely on this principle, a party must notify the other party in a timely manner, and provide evidence of the unforeseeable, unavoidable and insurmountable event within a reasonable time. Such evidence may take the form of 'force majeure certificates' issued by PRC authorities such as the China Council for the Promotion of International Trade (CCPIT). In this connection, the CCPIT has announced that exporters affected by the coronavirus outbreak can apply to it for such 'force majeure certificates'. The agency has also started issuing certificates to companies facing claims in relation to their failure to fulfil overseas orders.

It bears noting that such certificates may not be determinative; a PRC court or a foreign court or international arbitral tribunal may not accept a party's claim that a force majeure event has occurred even if that party has obtained such a certificate.<sup>5</sup>

In practice, whether the coronavirus outbreak constitutes a force majeure event will turn upon the specific facts, including the extent of the outbreak's impact on the parties' ability to perform their respective contractual obligations – in particular, whether the circumstances are truly unavoidable and insurmountable; whether the event was entirely unforeseeable; whether performance is wholly or only partially impossible; and the other facts of the case. During the 2003 SARS outbreak, the PRC courts found that the outbreak constituted a force majeure event in some cases, but not on the facts of other cases.

3. *Li Ching Wing v Xuan Yi Xiong* [2003] HKDC 54.

4. This bears some similarity to the concept of an 'impediment' under the UN Convention on Contracts for the International Sale of Goods.

5. In *Hoecheong Products Company Limited v Cargill Hong Kong Limited* [1995] UKPC 4a, the UK Privy Council considered a force majeure clause which required a certificate from the CCPIT, and what the certificate was required to contain under the terms of that clause. The Privy Council held that the requirement for a certificate was in addition to, not a substitute for, proof that facts existed that brought the force majeure exception into play.

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#### | *'Change of circumstances'*

In addition to the force majeure doctrine, PRC law has more recently recognised that a party who can show a 'change of circumstances' may be entitled to modify or terminate its contract. This has some similarities to the doctrine of imprévision under French law, but will be a novel concept to some common law lawyers.

Significantly, this doctrine applies even where continued performance of the contract is possible, but obviously unfair. The 'change of circumstances' must:

- have taken place after the contract was made and must have been unforeseeable at the time of the contract;
- not be caused by a force majeure event (as recognised under PRC law);
- not constitute a commercial risk, ie a normal market risk that can be reasonably anticipated and assumed by the parties; and
- be obviously unfair to a party, or one that would frustrate the contract, if the parties continue to perform the contract. For example, a party may argue that its manufacturing costs have significantly increased as a result of shortages caused by the coronavirus outbreak, and that it would be obviously unfair for the party to have to supply its products to its counterparty at the previously agreed price.

The contours of this principle, and how it differs from the concept of force majeure under PRC law, have yet to be fully explored. In particular, a key point of contention will likely be over what amounts to 'obviously unfair' or 'frustration' under PRC law, and how those standards are to be assessed – for example, does a sudden increase in the cost of raw materials by 50% amount to obvious unfairness, or do labour shortages caused by government-imposed quarantine measures frustrate the performance of a contract.

Whether a party affected by the coronavirus outbreak should claim force majeure or 'change of circumstances' will depend on the facts of the case. Significantly, different forms of relief are available. A 'force majeure' event would entitle the affected party to terminate the contract and/or be excused from liability; on the other hand, showing a 'change of circumstances' may also result in the PRC courts modifying the terms of the contract.

On one view, the remedy available under 'change of circumstances' is less draconian than that under force majeure, and it remains to be seen if it will become a more widely used remedy in the current circumstances. In an international context, interesting questions will also arise – as has been raised in the past – over whether the modification of a contract is a remedy which a common law court or an international arbitral tribunal may order.

## Partial performance

A party might find itself in the tricky position of being able to perform some but not all of its contracts. For example:

- an electronics manufacturer may have entered into two contracts, each for the supply of 500 tons of product, but the manufacturer only has 600 tons of product in its inventory due to supply chain disruptions;
- LNG terminals may be able to accept delivery from some but not all of its suppliers due to manpower shortages and lack of capacity, as downstream customers are prevented by transportation disruptions from taking delivery from the same terminals.

In these situations, that party will have to carefully consider the applicable law(s) and the terms of each contract, as these may stipulate whether they are to perform each contract on a pro-rata basis, or whether they are entitled to perform certain contracts and declare a force majeure or frustrating event in relation to others (and if so, whether they can choose the most 'lucrative' contracts to perform).

## Conclusion

Like the U.S.-China trade war and the social unrest encountered in Hong Kong in recent months, the coronavirus outbreak has the potential to significantly disrupt businesses and markets in Asia and beyond. To react quickly and decisively, parties will need to know what specific rights they have under their contracts, and the steps they need to take to protect those rights. The international nature of contractual relationships – and the multiple laws which potentially apply – further complicate the situation. The only certainty is that we will continue to see more difficult legal issues brought about by the coronavirus outbreak in the future.

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