

## Projects (Engineering and Construction) - July 2010

### Expect the Unexpected:

### Frustration, Changed Circumstances, and Force Majeure

This article compares and analyses three concepts, namely (1) Frustration of Contract, (2) Changed Circumstances, and (3) Force Majeure. All three concepts are comparable because one way or another, they deal with matters not expected at the time when the contract is formed. The article will examine their scope, and provide concrete examples of their application.

#### Introduction

Construction projects are full of unexpected events, from destruction of the subject matter of the contract, to appreciation or devaluation of the currency, to large increase in material costs, to changes in government policies, just to name a few.

When an unexpected event happens at your project, can you seek legal protection under (1) Frustration of Contract, (2) Changed Circumstances, and (3) Force Majeure?

#### Origin

Frustration of Contract is an established doctrine under Common Law jurisdictions such as Hong Kong, England, Australia and the US, while the concept of Changed Circumstances can be found in Civil Law Jurisdictions such as the PRC and Germany. The concept of Force Majeure can be found in Common Law as well and Civil Law jurisdictions.

#### Frustration of Contract

According to Lord Radcliffe in the English case of *Davis Contractors Ltd v Fareham UDC* [1956] AC 696, 729:

*"Frustration occurs whenever the law recognises that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for*

*would render it a thing radically different from that which was undertaken by the contract. Non haec in foedera veni. It was not this that I promised to do ..... There must be ..... such a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing from that contracted for"*

This statement has been explicitly approved by the House of Lords in subsequent cases. Common Law jurisdictions such as Hong Kong would follow the Common Law doctrine under English law.

#### Changed Circumstances

It is interesting that in the context of Frustration of Contract, Lord Radcliffe focused on "*the circumstance*" in order to consider whether it was "radically different". Lord Radcliffe's statement rhymes with the concept of Changed Circumstances under PRC law.

Article 26 of the No.2 Interpretation on Certain Issues in the Application of the Contract Law of the PRC (Fa Shi [2009] No.5), ie 最高人民法院关于适用《中华人民共和国合同法》若干问题的解释(二)(法释[2009]5号) ("*the Interpretation*") provided as follows:

*"In the event that after the formation of a contract, there are substantial changes to the objective circumstance which were unforeseeable by the parties at the time of entering the contract, and such changes were not caused by Force Majeure or categorized as commercial risk, and the continuous performance of the contract would result in obvious unfairness to one party or rendering the purpose of the contract unreachable, subject to requests by a party to vary or terminate the contract, the people's court shall decide whether or not to vary or terminate the contract in accordance with the principal of*

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*fairness and taking into consideration the actual situation of the case."*

Prior to 13 May 2009 (which was the date when the Interpretation took effect), there was no clear definition of Changed Circumstances, whether under the 1999 PRC Contract Law, or under other Interpretations from the PRC Supreme People's Court ("SPC"). As from 13 May 2009, the general opinion is that Article 26 set out the test for application of Changed Circumstances (although Article 26 did not adopt the phrase "Changed Circumstances").

### **Force Majeure - PRC Law**

Article 26 of the Interpretation expressly stated that Changed Circumstances dealt with situations "*not caused by Force Majeure*". Thus under PRC law, Changed Circumstances and Force Majeure are different concepts.

Article 117 of the PRC Contract Law entitled "*Force Majeure*" provided a succinct definition as follows:

*"For the purposes of this Law, Force Majeure means any objective circumstance which is unforeseeable, unavoidable and insurmountable."*

In this connection, Article 117 of the PRC Contract Law rhymes with the Force Majeure Clause 2003 published by the International Chamber of Commerce (ICC Publication No. 650, 2003 Edition), whereby Force Majeure was described in the following terms:

- That a failure to perform was caused by an impediment beyond the party's reasonable control
- That the party could not reasonably have been expected to have taken the occurrence into account at the time of the conclusion of the contract
- That the party could not reasonably have avoided or overcome the effects of the impediment.

Although Changed Circumstances and Force Majeure are different concepts under PRC law, they are similar to the extent that they share two common elements:

- objective circumstance
- unforeseeable

In the heading "*Application of the Concepts*" below, we shall examine different examples of Changed Circumstances and Force Majeure.

### **Force Majeure - Hong Kong and English Law**

McCardie J in the case of *Lebeaupin v Crispin* [1920] 2 KB 714 at 718, approved the following meaning of Force Majeure as applying to English contracts:

*"This term is used with reference to all circumstances independent of the will of man, and which it is not in his power to control"*

Force Majeure is wider in its meaning than the phrases "vis major" or the "Act of God". However, a Force Majeure clause should be construed in each case with a close attention to the words which precede or follow it and with due regard to the nature and general terms of the contract. The effects of the clause may vary with each instrument.

### **Can you contract out under PRC law?**

As seen in the immediately preceding paragraph, under Hong Kong and English law, the scope of Force Majeure can vary depending on the terms of the contract, ie you can contract out under those jurisdictions.

However, given that Article 117 of the PRC Contract Law has provided a definition of Force Majeure, and given that in Article 26 of the Interpretation the SPC set down the test for Changed Circumstances, can you contract out under PRC law?

Insofar as Force Majeure is concerned, learned authors cited Article 107 of the PRC General Principles of Civil Law which provided as follows:

*"Unless otherwise provided in the law, if a party cannot perform a contract or caused damages to*

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*another party because of Force Majeure, the party does not bear civil liability"*

Given the compulsory nature of Article 107 of the General Principles of Civil Law, the general consensus is that under PRC law, a party cannot contract out of Article 117 of the PRC Contract Law.

Thus even though your contract provides a definition of Force Majeure, if your contract is governed by PRC law, you may wish to consult Article 117 of the PRC Contract Law to find out whether a particular incident amounts to Force Majeure.

However, given that Article 26 of the Interpretation regarding Changed Circumstances is published by the SPC and is relatively new (taking effect as from 13 May 2009), and given that the PRC General Principle of Civil Law, the PRC Contract Law etc do not expressly provide for Changed Circumstances, the issue as to whether a party can contract out of Article 26 is less clear.

### **Application of the Concepts**

Successful application of the doctrine of Frustration of Contract includes:

- physical destruction of the subject-matter of the contract (in *Appleby v Myers* (1867) LR 2 CP 651, the buildings and the partly erected machinery therein was destroyed by fire)
- frustration of common venture (in *Jackson v Union Marine Insurance Co Ltd* (1874) LR 10 CP 125, a ship under charter ran aground, and took more than 6 months to refloat and complete repairs)
- government prohibition of, or restrictions on, building operations during wartime (*Federal Steam Navigation Co Ltd v Dixon & Co Ltd* (1919) 64 SJ 67)

However, Frustration of Contract is narrow and rarely applied under Hong Kong and English law. There are two principal reasons. First, the Courts do not wish to allow a party to appeal to the doctrine in an effort to escape from what has proved to be a bad bargain. Frustration is "*not lightly to be invoked to relieve contracting parties of the normal consequences of imprudent commercial bargains*" (*Pioneer Shipping*

*Ltd v BTP Tioxide Ltd (The Nema)* [1982] AC 724, 752). Second, where parties insert specific clauses dealing with specific events, the effect of such clauses will reduce the application of Frustration of Contract.

On the other hand, the concept of Changed Circumstances under PRC law appears to be wider.

In a Reply Letter given by the SPC, Fa Han (1992) No. 27 最高人民法院关于武汉市煤气公司诉重庆检测仪表厂煤气表装配线技术转让合同购销煤气表散件合同纠纷一案适用法律问题的函, 法函 [1992] 27 号, the SPC agreed that the lower court should interfere with a sale and purchase contract upon a large increase in material costs.

*"During the performance of the contract, circumstances changed to a degree that the parties could not foresee or avoid, ie the price of aluminium ingot, major raw material for production of gas meter components, rose to RMB 16,000 per ton, from RMB 4,400 to RMB 4,600 per ton, which range was state fixed price at the time of concluding the contract. Accordingly, the price of aluminium casing rose from RMB 23.085 to RMB 41 per set. It would obviously be unfair for Chongqing Testing Instrument Factory to provide gas meter components according to prices agreed in the original contract. Regarding this dispute between the parties, your Court shall decide the case in a fair and reasonable way, according to Clause 27, Sub-Clause 1, Item 4 of Economic Contract Law of the People's Republic of China, and in line with the actual conditions of the case"*

It is generally agreed that the above case illustrates that the SPC is prepared to apply the concept of Changed Circumstances, even before the publication of the Interpretation in May 2009. In subsequent cases, the PRC Courts have been prepared to interfere when there is a large increase in material costs.

In addition, learned authors suggested that other examples of Changed Circumstances include (1) physical destruction of the subject-matter of the contract, (2) appreciation or devaluation of the currency, (3) changes in government policies.

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However, given that the Interpretation regarding Changed Circumstances was recently published in May 2009, we have not been able to find cases specifically dealing the Interpretation. In the meantime, on 7 July 2009, the SPC published a Guiding Opinion (最高人民法院关于当前形势下审理民商事合同纠纷案件若干问题的指导意见 法发 [2009] 40 号) giving general guidelines such as how to distinguish "commercial risk" from Changed Circumstances.

Learned authors inside and outside the PRC generally agreed that Force Majeure includes natural disaster (earthquakes, tsunami), social unrest (war, riot, strike by workers). However, there are PRC cases which held that a ship collision due to inclement weather would qualify as force majeure (Hudong Shipyard 沪东造船厂 v Shanghai East Shujun Engineering Co Ltd 上海东方疏浚工程公司, decided by the Shanghai Intermediate People's Court in 2009).

### **The Consequences**

Upon the contract being frustrated, the contract comes to an end forthwith, without more and automatically, in the sense that it releases both parties from any further performance of the contract. The Courts do not have the power to allow the contract to continue and to adjust its terms to the new circumstances.

Contrast the above situation with Changed Circumstances, whereby the Courts have the power to "vary or terminate the contract" as per Article 26 of the Interpretation:

*"decide whether or not to vary or terminate the contract in accordance with the principal of fairness and taking into consideration the actual situation of the case."*

Given that the Courts in Hong Kong and England uphold the principle that the parties (rather than the Courts) should specify or vary the terms in a contract, whereas the PRC Courts are prepared to vary the

terms of a contract, such difference will continue to remain between the two systems.

As for Force Majeure, the effect is that the party affected is exempted from liability. Article 117 first paragraph of the PRC Contract Law provided as follows:

*"A party who was unable to perform a contract due to Force Majeure is exempted from liability in part or in whole in light of the impact of the event of Force Majeure, except otherwise provided by law. Where an event of Force Majeure occurred after the party's delay in performance, it is not exempted from liability"*

Further, the party affected should give notice. Article 118 of the PRC Contract Law provided that:

*"If a party is unable to perform a contract due to Force Majeure, it shall timely notify the other party so as to mitigate the loss that may be caused to the other party, and shall provide proof of Force Majeure within a reasonable time"*

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We have prepared and will prepare a series of articles on the following issues, focusing on various areas of the law by comparing PRC and non-PRC concepts. All the articles are designed to present you with the whole picture so that you will be best equipped to deal with a whole spectrum of critical business and legal issues.

1. Expect the Unexpected: Frustration, Changed Circumstances, and Force Majeure
2. Guarantee Contract and Principal Contract: Conflicts in Jurisdiction
3. Time Bar and Benefitting from One's Own Wrong
4. Liquidated Damages

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