

Kira Study

The Effects of Force Majeure in Contracts





Growing Concern: The Effects of Force Majeure in Contracts

The current coronavirus pandemic has inflicted major damage on global supply chains and commodities markets. As of March 11, 75% of companies reported experiencing supply chain disruptions in connection with the pandemic, with more than 60% of businesses subjected to delays in their orders from China. Chinese businesses are still struggling with fulfilling their contractual obligations. The impact this has had on supply chains is so significant that companies are beginning to warn their investors of the risks. In particular, the automotive and technology industries have suffered in comparison to other industries. China, one of the world's largest consumers, has seen auto sales drop by 79% in comparison with last year, and its smartphone sales decrease by 55% compared to last year. With the pandemic's spread now reaching worldwide, parts shortages that have not yet been resolved, and new travel restrictions being implemented daily, the impact has expanded beyond China. The Moody's global vehicle sales forecast was revised downward to a decrease of 2.5% in sales in 2020 rather than the originally forecasted decrease of 0.9%. European auto factories have even suspended operations, and Silicon Valley companies saw their stock prices fall anywhere between 6.5% to 13.5% on March 12. Although technology companies in China are beginning to resume operations, the delays are still rippling through the rest of the world, so the full impact of the coronavirus pandemic remains to be seen.

The China Council for the Promotion of International Trade has now issued more than 5,600 force majeure certificates that cover a total contract value of 503.5 billion Chinese yuan (US\$72.47 billion)—nearly five times the contract value covered in early February. The certificates, which acknowledge the pandemic as a force majeure event and seek to absolve the recipient businesses from liability for non-performance or partial performance under relevant contracts. Force majeure provisions in contracts establish the circumstances under which a party's obligations under the contract may be suspended, or otherwise altered, due to events deemed to be out of the affected party's control. Examples include natural disasters, acts of terrorism or war, acts of God, labor disruptions, or even pandemics. As we have previously noted, force majeure provisions are important because the occurrence of

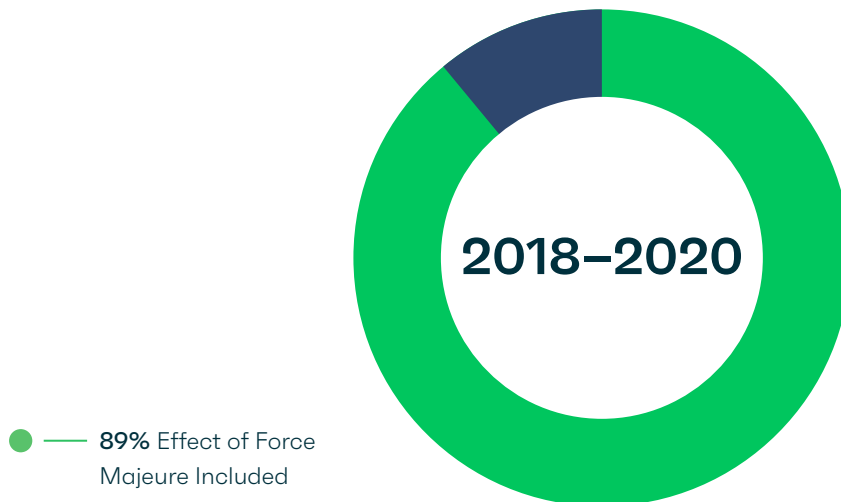


a force majeure event can result in any number of effects such as a party's exemption from performing its contractual obligations (important to the non-affected party), potential notification requirements (important to the affected party), or even the possibility of terminating the contract altogether (important to all parties).

As a follow-up to our [previous force majeure study](#), we reviewed the same Chinese commercial contracts to determine the types of consequences that would follow if a force majeure event was determined to have occurred. Within seven hours, we were able to use Kira to review substantially all of the commercial contracts filed on EDGAR between February 2018 and February 2020 that involved at least one Chinese entity and contained force majeure provisions to identify, categorize and analyze those consequences.

Effects of Force Majeure on Commercial Contracts

Our previous analysis in Kira indicated that many of the contracts provided for procedures to be followed in the event of a force majeure occurrence. Out of the 130 contracts, 94 contracts, or 72%, included force majeure provisions. Of those 94, 89% included language specifying the effects a force majeure event would have on the contracts.



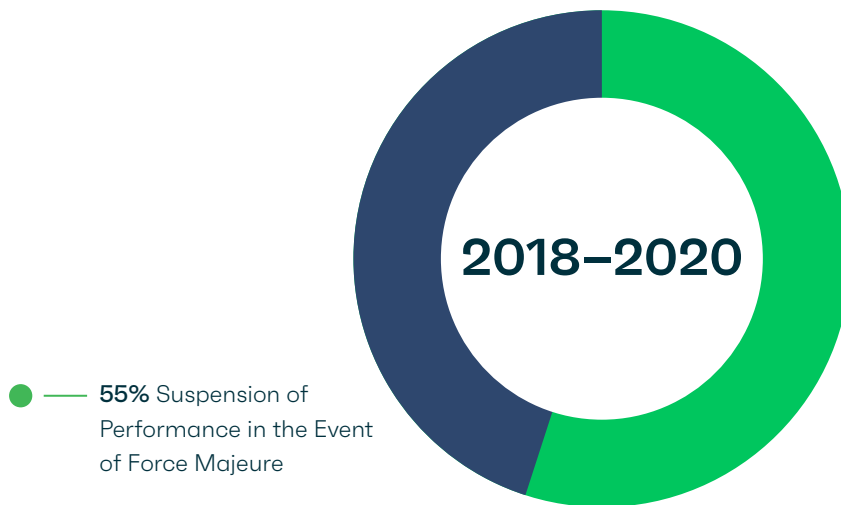
Source Data: 94 commercial contracts involving at least one Chinese entity with force majeure provisions, filed on EDGAR between February 2018 and February 2020, analyzed using Kira.

Our analysis in Kira indicated that these consequences for the most part fall into three main categories—(1) temporary suspension of performance; (2) consultation and discussion of modifying the contract obligations; and (3) at the extreme end, termination of the contract. A number of the contracts included more than one consequence in the event of force majeure, so the totals below exceed 100% when added together.



Effects of Force Majeure on Contracts: Suspension of Performance

Over half of the contracts that addressed the effects of force majeure included language providing for temporary suspension or postponement of the affected parties' obligations (after satisfaction of applicable notice requirements), with the requirement to resume performance after the force majeure condition is eliminated.¹



Source Data: 84 commercial contracts involving at least one Chinese entity with force majeure provisions that included consequences of force majeure, filed on EDGAR between February 2018 and February 2020, analyzed using Kira.

The ability to suspend and postpone performance under the contract without liability, from the supplier perspective, is the most supplier- and service provider-friendly. Purchasers that have suspension and/or postponement language in their contracts are more exposed to the risks associated with force majeure. Since so much depends on their counterparties' willingness (but not obligation) to work together and communicate openly about their ability to perform their contractual obligations, purchasers are more limited in the available remedies to them during a force majeure event.

¹ Examples include the following:

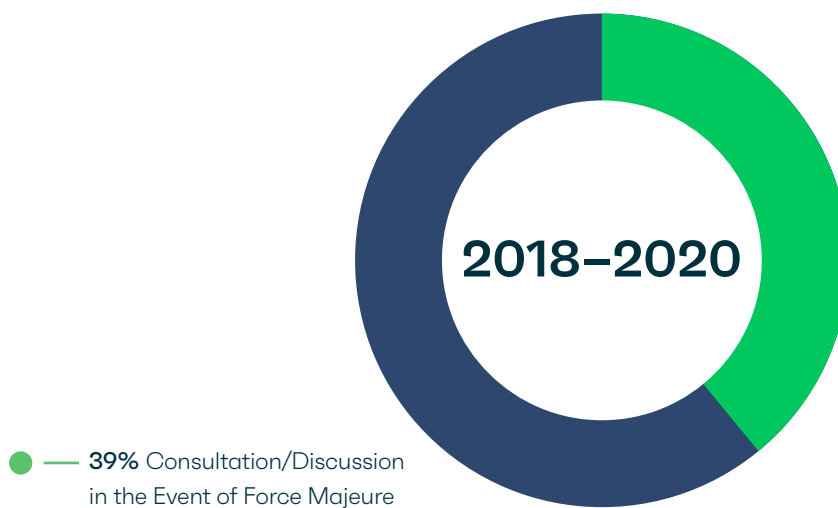
"The affected party may temporarily suspend the performance of its obligations under this Contract until the effects of the event of force majeure are eliminated."

"If any Force Majeure Event results in the failure of the affected Party in performing any of its obligations hereunder, the obligation hereunder failing to be performed shall be suspended within the duration of the Force Majeure Event, and its date of performance shall be automatically extended to the date when the Force Majeure Event ends, and the Party failing to perform its obligation shall not be subject to any penalty."



Effects of Force Majeure on Contracts: Consultation/Discussion

A significant portion—39%—of the force majeure provisions with consequences stated that if a force majeure event occurs, the parties will consult with each other to determine what course of action to take. In our review, this varied from modifying the contract, waiving or postponing the contractual obligations, to deciding whether or not to keep the contract in effect.²



Source Data: 84 commercial contracts involving at least one Chinese entity with force majeure provisions that included consequences of force majeure, filed on EDGAR between February 2018 and February 2020, analyzed using Kira.

While the parties to a contract can generally mutually agree to modify and amend the contract at any time during the contract’s term, including the obligation to consult and/or discuss the options on the occurrence of a force majeure event should provide a more balanced outcome for the parties involved. Communication is key in urgent situations, and the consultation/discussion remedy provides the parties with flexibility in developing a workable solution for their contractual relationship.

² Examples include the following:

“The Parties shall consult each other and decide whether this Agreement shall be waived in part or postponed in its performance with regard to the extent of impact of such force majeure event on the performance of this Agreement.”

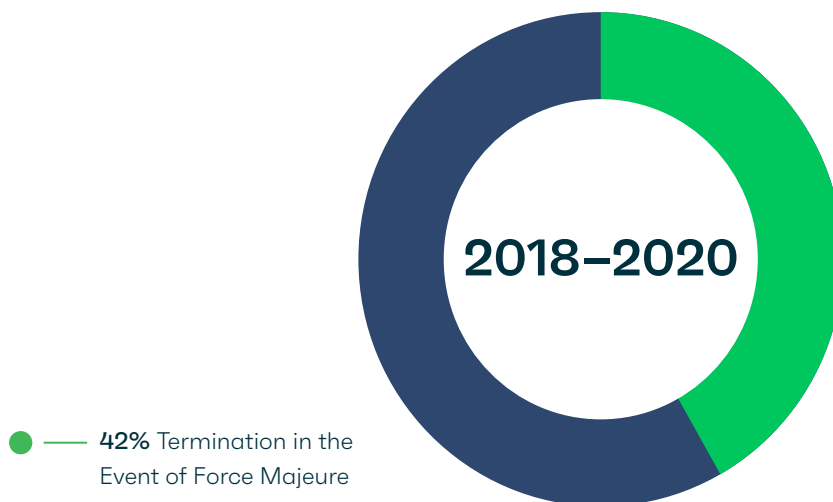
“In the event of Force Majeure, the Parties shall immediately consult with each other to find an equitable solution and shall use all reasonable endeavours to minimize the consequences of such Force Majeure.”

“After occurrence of the event of force majeure, both parties shall consult immediately to agree on a fair solution (which may include early termination or extension of the term of this Agreement) and shall make every reasonable effort to reduce the consequences of such force majeure.”



Effects of Force Majeure on Contracts: Termination

At the other end of the spectrum and the most serious consequence of force majeure, 42% of the force majeure provisions with consequences allowed one or more of the parties to terminate the contract on or after a specified period of time following a force majeure event. The time for the parties to decide to terminate their contracts ranged from immediately to six months of non-performance under the contract.



Source Data: 84 commercial contracts involving at least one Chinese entity, filed on EDGAR between February 2018 and February 2020 with force majeure provisions that included consequences of force majeure, analyzed using Kira.

The termination remedy is the most purchaser-friendly since it facilitates a purchaser's ability to source materials or services from alternative sources if a force majeure event happens. As the most serious remedy a supplier or service provider may be exposed to, it may also provide purchasers with the ability to terminate contracts that are no longer favorable to them. Conversely to the suspension/postponement remedy, much of the outcome will depend on purchasers' willingness to maintain open communications and work with their counterparties to ensure contract continuity.

³ Examples include the following:

"If this Contract cannot be performed due to any force majeure event, both Parties shall cancel this Contract in good manner and shall not be liable for the breach of contract or compensation."

"If any of following circumstances or events occurs or happens, this Agreement may be terminated in accordance with Article 6.3 hereof during the continuance of such circumstance or event; (a) Either Party has ceased performing its obligations for at least six (6) months due to any Force Majeure Event (defined in Article 10 hereof) . . ."



Conclusion

The volume of contracts that may warrant review for force majeure provisions continues to grow. Businesses dealing with affected entities should:

- Review all relevant contracts for force majeure provisions that mention or include: public-health related events; government acts; and/or “catch-all” language in order to anticipate whether those contracts may be affected by the coronavirus pandemic.
- Regardless of whether the business is “affected party” or the “non-affected party”, review any applicable notification requirements to ensure they are followed.
- Review what the consequences and remedies are in the event a force majeure is determined to have occurred, so the parties can jointly develop a plan to either preserve contract continuity or, if it makes sense, terminate it.
- In drafting commercial contracts going forward, consider not only including events such as epidemics, outbreaks or pandemics in the definition of force majeure to avoid ambiguity, but also clearly stated effects on the contract should a force majeure event occur.

The consequences and remedies relating to force majeure events may simply be boilerplate language that has been copied and pasted, or they may reflect the relative bargaining power of the parties during contract negotiations. But the coronavirus pandemic is an unprecedented global event that has left businesses in uncharted territory, so it is possible that contracting parties may be more open to discussion than originally contemplated. In any case, it’s paramount to understand the rights and obligations of the parties in the contract as part of preparing for discussions with contract counterparties and establishing alternative plans when full performance of a contract is not possible.

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