

Legal Analysis

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Non-performance of Hong Kong Contract due to Outbreak – How to Tackle with Action Checklist?

Executive Summary

The recent unexpected outbreak of coronavirus in China and the responding measures to contain the spread of the virus have no doubt disrupted the country's daily business activities. Corporations should take immediate actions to assess to what extent their operation is being affected by the outbreak and whether they have failed or will likely fail to perform any contracts because of the outbreak, especially, depending on how the contract is worded, in the case of a breach, the affected party might be held liable to compensate the counterparty such as by way of liquidated damages.

In this article, we have discussed the use of the force majeure clause in business contracts to avoid the liabilities of the affected parties arising from the non-performance as well as the key issues that should be considered under Hong Kong laws. The analysis of the force majeure clause is fact sensitive and we have used a sample clause to elaborate on the complexities in practice.

If a force majeure clause is not in the contract or does not apply to the scenario, the affected party may resort to the doctrine of frustration to discharge itself from the performance of the contract, but, for reasons to be discussed, it can be more difficult to prove that the contract has been frustrated at common law compared with invoking an express force majeure clause.

To assist you in tackling the potential crisis on a step by step basis, we have prepared an action checklist at the end of this article for your reference in this era of uncertainties.

Introduction

On 30 January 2020, the World Health Organization (WHO) declared the outbreak of coronavirus in China as a "public health emergency of international concern". The potential implication of such declaration can be significant to multinational companies with business presence in, or trade relations with, China. The travel and potentially trade restrictions into and out of China imposed by other countries as a result of such declaration, the extended public holiday in China and the restrictions on movement among certain provinces and cities within the country have all posed a challenge to the stability of the supply chain of various international businesses. As a result, some of the multinational corporations may find it difficult or impossible to continue to perform their obligations under the existing contracts.

So far as we are aware, some of our clients are assessing to what extent their operation and supply chain will be adversely affected by this outbreak and are implementing measures to minimize the impact to their businesses in the region. We set out below the questions they will likely ask in relation to their potential inability to perform the existing contracts during the outbreak and our high level comments for your reference.

Scenario

A company ("Company A") may be unable to fulfil its contractual obligations with the international client because its mainland suppliers cannot deliver the goods to Company A in time due to the shortage of factory workers and truck drivers, an outcome of the extended public holiday in China and the restrictions on travel among certain cities during the outbreak. Can Company A's international client sue Company A for breach of contract?

If the underlying contract is governed by Hong Kong laws, then under normal circumstances, a claim for damages for breach of contract would be a possible remedy. If it is clear that the breach was principally caused by an outbreak of epidemic or other crisis which is beyond the control of either party, a claim for breach may fail and the party alleged to be in default may be released from the relevant contractual obligations if either:

1. the force majeure clause in the relevant contract applies; or
2. the common law doctrine of frustration applies.

Which defence is better?

The next question that naturally follows is whether the affected party should defend against the claim by the force majeure clause or the doctrine of frustration. If there is already an applicable force majeure clause in the contract, as discussed below, it is always easier to rely on such express provision instead of invoking the doctrine of frustration given the latter's higher threshold to meet at common law. If there is no force majeure clause in the contract, the affected parties will have no choice but resorting to other remedies such as the doctrine of frustration.

In response to client's question, to confirm if Company A would be liable to compensate its international client for its breach attributed to the outbreak, Company A needs to first carefully review the wording of the force majeure clause in the relevant contract (if it is there) to check if such outbreak is covered and if there are any additional requirements that must be satisfied before such clause is being relied on as a defence.

Then what's a force majeure clause and how do we know if such clause in our contract applies to this outbreak?

Force Majeure

A force majeure clause typically excuses the parties from performance of the contract following the occurrence of certain events beyond the parties' reasonable control. Different from the contract law of the mainland China which prescribes the meaning of force majeure, there is no recognised meaning of the term "force majeure" in the laws of Hong Kong, its scope varies in each case subject to the

particular words used in the contracts. Set out below is a sample force majeure clause for illustration purpose:

"If either party is prevented, hindered or delayed in or from performing any of its obligations under this agreement by any events, circumstances or causes beyond its reasonable control, such affected party shall not be in breach of this agreement or otherwise liable for any such failure or delay in the performance of such obligations and the time for performance of such obligations shall be extended accordingly."

The existence of a force majeure clause does not necessarily release the affected party from its obligations to perform the contract. The wording of the force majeure clause in your contract may be different from the above sample clause, the application of which has to be considered on a case by case basis.

Is the outbreak a force majeure event?

The first thing you need to check is whether the coronavirus outbreak is covered by the definition of force majeure in the contract. In some of the short-form clauses like the above sample, it only refers to "any events, circumstances or causes beyond its reasonable control" without including any list of examples of types of such events, circumstances or causes. This may give rise to disputes between the parties over whether any particular event could be categorized as a triggering force majeure event.

Hence, an expressly defined term "force majeure event" with a list of examples provides more clarity. If parties have a well-defined term "force majeure event" which covers epidemic, it is clear that the outbreak shall be covered by the force majeure clause. Generally, in addition to epidemic or pandemic, the defined term "force majeure event" will commonly cover acts of God, flood, drought, earthquake or other natural disaster, terrorist attack, civil war, civil commotion or riots, war, threat of or preparation for war, imposition of sanctions or embargo, nuclear, chemical or biological contamination and any law or action taken by a government or public authority.

There is often one or more other events that may also be applicable in the event of an epidemic. For instance, the cross-provincial travel restrictions imposed by local governments to contain the spread of the virus resulting in disruptions to the logistics activities may be regarded as actions taken by the government and hence a force majeure event.

The declaration of the outbreak of coronavirus in China as a "public health emergency of international concern" by WHO may be proof of the existence and severity of the coronavirus as an epidemic or, if epidemic is not expressly covered by the clause, as an event beyond any reasonable control of either party. The China Council for the Promotion of International Trade has recently decided to issue to the affected businesses certificates attesting the force majeure event, which may also serve as one of the supporting evidence to attest the existence of the outbreak as a force majeure event under Hong Kong laws.

Is the outbreak not reasonably foreseeable?

However, there is no guarantee of success and it all depends on the words chosen, the surrounding circumstances and the parties' intention. For example, some of the force majeure clauses may further require that such events, in addition to be "beyond parties' reasonable control", need to be "not reasonably foreseeable to the parties at the time of entering into the contract". The relevant questions to consider shall include:

- When was the contract signed?
- Was it signed before or during the outbreak?
- Were the authorized signatories aware of the outbreak at the time of signing the contract?
- Were the authorized signatories situated in China such as Wuhan City and did they have access to news related to the outbreak?

If there is evidence suggesting that the outbreak would be foreseeable to any reasonable man at the time of entering into the contract, the affected party may not be able to use the force majeure clause as a valid defence to avoid their liabilities.

Are the non-performance and outbreak duly notified to the other party?

It is important to note that, in some of the force majeure clauses, the affected party may be required to notify the other party of the force majeure event in the prescribed manner and within a prescribed period of time, such as 7-14 days, after the occurrence of such event. If you intend to rely on a force majeure clause, please be reminded to ensure your staff, sometimes junior, has strictly complied with the notice requirement set out in the clause.

Does the notice to invoke a force majeure event need to be signed? By whom? Can it be delivered to the other party by e-mail instead of fax or courier, in particular the staff are working from home? Is the correct fax number or business address being used? There are case laws where the affected party failed to invoke the force majeure clause as a defence due to its failure to duly comply with the notice requirements by oversight.

Is the non-performance caused by the outbreak?

It is equally important to check if such event in fact "caused" the non-performance. Depending on the exact words used, if they provide that the relevant force majeure event must "prevent" performance, based on the case law, the affected party must demonstrate that performance is legally or practically impossible, not just difficult or more costly. To the contrary, the threshold of the words "hinder" and "delay" is lower, and will generally be satisfied if performance is substantially more onerous. However, an increase in the cost of continuing to perform the contract may still be insufficient to satisfy the requirements of such wording.

For example, if the mainland supplier of Company A was already in poor financial condition 3 months ago and has failed to pay the salaries to its workers since then, the supplier would be unable to meet the orders of Company A in any case regardless of the outbreak. In such case, Company A would not succeed in proving that the outbreak has prevented its performance of the contract. Further, if Company A could instead source the goods from factories in Vietnam or other countries not significantly affected by the coronavirus to fulfil its contractual obligations, albeit at higher costs, the force majeure clause also may not be applicable.

Does the force majeure event terminate the entire contract?

It is worth mentioning that, if we take the above sample clause as an example, even though all the requirements are satisfied, the affected party is only excused from the performance during the occurrence of the relevant force majeure event and the contract itself is not terminated. As soon as the force majeure event disappears or ceases to prevent or hinder the performance of the affected party, the affected party should resume the performance of its contractual obligations. That said, there are certain force majeure clauses which allow either party to terminate the contract if the force majeure event has sustained for a period of time, say 3 months, and in such case, the contract will be terminated and the parties' obligation to perform will be discharged. As reiterated before, the relevant legal analysis is always fact sensitive.

What if there is no force majeure clause in our contract? What are the alternative defenses?

Frustration

If there is no force majeure clause in the contract or the clause does not apply to your scenario, then as said you may consider alternative routes like the common law doctrine of frustration. A contract may be terminated on the ground of frustration when, without the fault of the party seeking to rely on it, something occurs after the formation of the contract which renders it physically or commercially impossible to fulfil the contract, or the obligation would be significantly different to what was contemplated by the parties when the contract was formed.

An uphill battle?

When a frustrating event occurs, the parties are excused from further performance and are not liable for damages for non-performance. However, different from a force majeure clause without a termination option, a frustrated contract will be permanently terminated but not temporarily suspended. Accordingly, as the entire contract is terminated once held to be frustrated, the Hong Kong courts tend to be prudent and are typically reluctant to find that a contract has been frustrated.

A force majeure clause will normally prevent the contract from being frustrated, meaning that you may invoke either the force majeure clause or the doctrine of frustration, but not both. According to case law, a contract will not be frustrated simply because it becomes more difficult or more expensive to perform, so, as discussed above, if you can find alternative sources of raw materials or products, or your staff being quarantined at home remain able to access the emails and provide the required services to the customers, it is less likely that you can invoke the doctrine of frustration to terminate the contract.

To be pragmatic – talk to the other side?

Whether the force majeure clause or the doctrine of frustration is available to you as a defence, it is advisable to, on a without prejudice basis, engage with the counterparties of the business contracts at the early stage and throughout the period being affected to let them be aware of the difficulties you are facing and the actions you have taken and will take to mitigate the adverse effects and losses caused by such force majeure event.

It would save both time and costs for the contracting parties to agree on a mutually acceptable interim arrangement during the affected period (such as alternative supply or time extension) compared with taking a non-cooperative stance at the outset and resolving the disputes over the non-performance in subsequent legal proceedings. Transparency is the key to get rid of any misunderstanding between the parties.

Action Checklist - key legal considerations arising from a force majeure event

In summary, here are the key points for you to self-check if you can be discharged from the relevant contractual obligations given the outbreak of coronavirus:

Step	Action Item
1.	Communicate with the operational team to check if the company or any of its subsidiaries has failed, or will likely fail to, perform any of its obligations in any business contracts
2.	Investigate the causes of the failure to see if any of them directly or indirectly relates to the outbreak of coronavirus and collect the relevant evidence to discharge the burden of proof of the affected party (including but not limited to the quantity and location of the affected goods and the causal relationship with the outbreak)
3.	Review the business contracts to check if there is a force majeure clause
4.	If there is a force majeure clause, review the definition of the force majeure event to confirm if the outbreak of coronavirus is covered
5.	Consider other elements of the force majeure clause, e.g. causation, notice and not reasonable foreseeable, to form a preliminary view as to whether such clause applies to your scenario, and if yes, whether all the prescribed procedures have been followed
6.	Mobilize all the internal resources and consider if there are alternative ways to perform the contract and at what price

7.	If appropriate, on a without prejudice basis, communicate with the counterparties of the relevant contracts and keep them informed of the force majeure event and the actions being taken to mitigate the losses
8.	Conduct a comprehensive review of all the business contracts and standard terms of business to ensure there is a properly drafted force majeure clause which covers pandemics, epidemics and other crisis situations

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