

Dispute Resolution Law

2019-nCoV Outbreak and Contract Disputes (I)

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The novel coronavirus (**2019-nCoV**) outbreak has affected the performance of numerous civil and commercial contracts. In this article, we examine the general legal impact of the outbreak on the performance of contracts from two perspectives, namely: 1) force majeure and 2) change in circumstances. We identify the relevant legal issues involved from these two perspectives and put forward our preliminary analysis for your reference.

Generally speaking, the novel coronavirus outbreak may constitute a force majeure event, based on the views of PRC courts on judicial practice when handling cases during the 2003 SARS epidemic. Nevertheless, whether the parties to a contract are entitled to claim exemption from liability or rescission based on the outbreak must be analyzed on a case-by-case basis. In particular, whether the outbreak would inevitably lead to a failure to perform the contract or the frustration of the purpose of the contract must be examined in accordance with the specific circumstances of each case. If the novel coronavirus outbreak does not constitute a force majeure event, it could be deemed as a change in circumstances. When there is a change in circumstances, the court may have discretion to modify or rescind the contract based on a party's request and the principle of fairness. According to previous judicial practice, PRC courts generally take a cautious approach when applying the principle of change in circumstances.

Force Majeure, Exemption from Liability and Rescission of Contract

I. Does the novel coronavirus outbreak constitute a force majeure event?

We are of the opinion that the novel coronavirus outbreak may constitute a force majeure event.

Assuming the contract contains a "force majeure" provision, and "infectious disease" or "atypical pneumonia" is explicitly listed as one type of force majeure event, then the parties have a contractual

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basis to claim that the novel coronavirus outbreak constitutes a force majeure event.

If there is no "force majeure" provision in the contract, or the "force majeure" provision does not explicitly list "infectious diseases" or "atypical pneumonia" as one type of force majeure event, the parties may nonetheless claim that the outbreak of novel coronavirus constitutes a force majeure event based on the following legal provisions and judicial practices.

1. Legal provisions

Pursuant to Article 180 of the General Provisions of the Civil Law and Article 117, paragraph 2 of the Contract Law, force majeure refers to "objective circumstances that are unforeseeable, unavoidable and insurmountable".

We believe that the outbreak of novel coronavirus could not have been foreseen by the general public and was unexpected. To date, no effective method has been found to completely stop the spread of the virus, and no effective cure has been discovered. Accordingly, at least for now, parties to a contract can claim that the outbreak is an unforeseeable, unavoidable, and insurmountable event of force majeure. However, whether a PRC court will support such a claim requires analysis in accordance with the specific circumstances of each case.

2. Judicial practice

To date, the Supreme People's Court has not issued any judicial documents regarding how to address contract disputes arising from the novel coronavirus outbreak.

Considering that the outbreak is similar to the 2003 SARS epidemic, significant referential value may be drawn from the views of the Supreme People's Court and local courts on judicial practice in adjudicating contract disputes arising out of the SARS epidemic.

- **Article 3, para. 3 of the *Circular of the Supreme People's Court on Carrying out the Work of the People's Courts Related to Trials and Judgment Enforcement in Accordance with Law During the SARS Epidemic***² (Fa [2003] No. 72, effective 11 June of 2003):

"... Disputes arising from the impossibility to perform a contract directly due to administrative measures taken by the government and relevant departments to prevent or control the SARS epidemic, or failure to perform a contract due to the impact of the SARS epidemic, shall be properly dealt with in accordance with Article 117 [the force majeure provision] and Article 118 of *Contract Law of the People's Republic of China*."

- ***Properly Handling Cases in which Parties Claim the SARS Epidemic as a Force Majeure Event for Exemption of Liability***³ (Research Group of Beijing No. 2 Intermediate People's Court)

"Despite that medical experts hold different views on the symptoms and causes of SARS, from a legal

² This notice has been abolished pursuant to the Decision of the Supreme People's Court on Abolishing Some of the Judicial Interpretations and Documents of Judicial Interpretation Nature Promulgated from July 1, 1997 to December 31, 2011 (Fa Shi [2013] No.3).

³ Published in *Journal of Law Application* (《法学适用》), Issue No. 207 in June of 2003.

perspective, we believe SARS is an unexpected abnormal event and a worldwide epidemic. The outbreak of SARS was not only unforeseeable for the parties in dispute, but was also unforeseeable for medical experts with extensive medical knowledge. Since the [SARS] outbreak, there has been no effective method to stop its spread, and the source of infection has not been identified. Although that many SARS patients have been cured and discharged from the hospital, medical experts have not yet discovered any effective treatment method. Therefore, **at least for now, this abnormal event is an objective circumstance that was unforeseeable, unavoidable, and insurmountable by humanity. Legally speaking, it shall be deemed as a force majeure event. It is a type of natural disaster."**

II. If the novel coronavirus outbreak constitutes a force majeure event, what are the corresponding legal consequences?

The legal consequences of a force majeure event should be analyzed from the following two perspectives.

First, the parties may have agreed in the contract on the relevant legal consequences. If there are terms in the contract setting out how the contract is to be performed after the occurrence of a force majeure event, the parties should perform in accordance with such terms.

Second, PRC law has provisions on the legal consequences of force majeure events. Nevertheless, whether the provisions regarding the legal consequences are applicable depends on the specific circumstances of each case.

1. Parties may claim partial or full exemption from contractual liability

Pursuant to the following legal provisions, if the obligations under a contract cannot be performed due to a force majeure event, the party that fails to perform its obligations may claim partial or full exemption from liability. It bears mentioning that the party claiming such exemption is required to prove that there is a causal relationship between the novel coronavirus outbreak (as a force majeure event) and its failure to perform the obligations.

■ **Article 180, para. 1 of the *General Provisions of the Civil Law***

"If a party is unable to perform civil obligations due to a force majeure event, the party shall not bear civil liability. If other provisions of law stipulate otherwise, such provisions shall prevail."

■ **Article 117, para. 1 of the *Contract Law***

"A party who is 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 force majeure event, except as otherwise provided by law. Where an event of force majeure occurs after the party's delay in performance, it is not exempted from such liability."

2. Parties may claim rescission of the contract

Pursuant to the following legal provisions, if the purpose of the contract is frustrated due to a force majeure event, either party may claim rescission of the contract. However, the party claiming

rescission would be required to prove a causal relationship between the novel coronavirus outbreak (as a force majeure event) and the frustration of the purpose of the contract.

■ **Article 94 of the *Contract Law*:**

"The parties to a contract may rescind the contract under any of the following circumstances:

a. the purpose of the contract is rendered impossible to achieve due to an event of force majeure; ..."

3. Parties may claim inapplicability of the deposit penalty rule

If the contract provides for a deposit and the contract cannot be performed due to a force majeure event, the affected party may claim that the deposit penalty rule does not apply, provided the party proves a causal relationship between the force majeure event (in this case, the novel coronavirus outbreak) and the failure in performing under the contract.

■ **Article 122 of the *Interpretation of the Supreme People's Court on Several Issues concerning the Application of the Guaranty Law***

"Where the principal agreement cannot be fulfilled due to force majeure or any accident, the deposit penalty rule shall not apply..."

It should be particularly noted that whether the party affected by the novel coronavirus outbreak can claim exemption from liability or rescission of a contract by arguing force majeure should be analyzed on case-by-case basis.

Key factors to consider include whether the outbreak will inevitably lead to a failure to perform the contract or the frustration of the purpose of the contract; whether the claiming party itself is also at fault, i.e. whether the failure in performing the contract during the outbreak resulted from delayed or improper performance by the claiming party, etc.

In addition, the measures for preventing and controlling the outbreak of novel coronavirus taken by relevant government departments and local governments during different periods are also important factors.

III. What are the legal considerations/obligations of contracting parties when the performance of the contract is affected by the novel coronavirus outbreak (as a force majeure event)?

Contracting parties should consider issues from the following two perspectives.

First, from the perspective of the contractual provisions. If the contract provides for post-force majeure arrangements, such arrangements will apply.

Second, from the perspective of legal provisions. In such case, relevant legal provisions provide obligations respectively for the defaulting party and the non-defaulting party.

For the party in default, its obligations include notifying the other party in a timely manner and providing evidence of the force majeure event within a reasonable period, according to the following legal provisions. Based upon the judicial practice of the PRC courts in handling similar cases during the

SARS epidemic, the occurrence of a force majeure event should be easy to prove considering the outbreak of novel coronavirus epidemic has become a "socially known fact".

■ **Article 118 of the *Contract Law*:**

"If a party is unable to perform a contract due to an event of force majeure, it shall timely notify the other party so as to mitigate the losses that may be caused to the other party, and shall provide evidence of such event of force majeure within a reasonable period."

The non-defaulting party has the obligation to "take the appropriate measures to prevent further losses", according to the following legal provisions.

■ **Article 119 of the *Contract Law*:**

"Where a party has breached the contract, the other party shall take the appropriate measures to prevent the losses from increasing; where the other party's failure to take appropriate measures results in additional losses, it cannot demand compensation for the additional losses.

Any reasonable expense incurred by the other party in preventing additional losses shall be borne by the party in breach."

Change in Circumstances and Modification/Rescission of Contracts

I. What is the difference between force majeure and change in circumstances? Can they be applied at the same time?

The current PRC judicial interpretation interprets "change in circumstances" as follows:

■ **Article 2 of the *Interpretation of the Supreme People's Court on Several Issues Concerning the Application of the Contract Law of the People's Republic of China (II)*⁴ (Fa Shi [2009] No. 5, effective on May 13, 2009):**

"Where a party to a contract petitions the court to modify or rescind the contract on the grounds that the continued performance of the same is patently unfair to the party or the purpose of the contract will not be realized due to occurrence of any material change in circumstances that was unforeseeable, not caused by force majeure, and not a commercial risk after the conclusion of the contract, the court shall decide whether the contract shall be modified or rescinded according to the principle of fairness on a case-by-case basis."

A similarity exists between force majeure and change in circumstances, i.e. the occurrence of each should be "unforeseeable". However, as we discuss below, there is fundamental difference between these two obstacles to performance which does not allow for the two to be applicable at the same time.

1. Force majeure and change in circumstances both constitute obstacles to the performance of a contract, but to differing degrees. Specifically, force majeure completely prevents the performance of a

⁴ According to *Decision of the Supreme People's Court on the Abolition of Certain Judicial Interpretations and Judicial Interpretation-Quasi Documents (Tenth Batch) Published Between July 1, 1997 and December 31, 2011* (Fujian [2013] No. 7), the circular has been revoked.

contract, while a change in circumstances does not. Upon occurrence of a change in circumstances, the continued performance of the contract is still possible, but doing so becomes extremely difficult and obviously unfair to one party.

2. Force majeure is a statutory exemption from liability, which means that the affected party is exempted from liability for failure to perform as long as the party can prove that the failure resulted from the force majeure event. In such cases, whether or not to exempt the liabilities is not at the discretion of the court. However, change in circumstances is not a statutory exemption from liability. The parties are only entitled to claim for the modification or rescission of the contract by claiming a change in circumstances, and the court has discretion to decide whether the contract should be modified or rescinded.
3. Force majeure automatically acts to relieve the defaulting party of liability, whereas a court has discretion in determining the effect of a change in circumstances. This means the court may decide whether there exists a change in circumstances, whether the agreement will be modified or rescinded due to the change in circumstances, and whether the affected party will be exempted from liability upon the occurrence of the change in circumstances.
4. Change in circumstance is used to challenge the validity of a contract and aims to resolve the question of whether the contract should continue to be performed if the circumstances upon which the contract was concluded have changed. In contrast, force majeure is invoked when a party is in breach of contract due to a force majeure event and aims to resolve the question of whether the party in breach must bear liability. Thus, the two exemptions aim to resolve different problems.

II. Does the novel coronavirus outbreak constitute a change in circumstances?

The novel coronavirus outbreak may be deemed to constitute a change in circumstances, based upon the previous provisions of the Supreme People's Court and views of some courts when handling similar cases during the SARS epidemic (see below). In such cases, courts may order the affected contract to be modified or rescinded upon the request of either party in certain cases even if the novel coronavirus epidemic is not held to constitute force majeure.

- **Article 3, para. 3 of the *Circular of the Supreme People's Court on Carrying out the Work of the People's Courts Related to Trials and Judgment Enforcement in Accordance with Law During the SARS Epidemic*:**

"Where the performance of a contract in accordance with its original provisions significantly affects the rights and interests of either party to a contract due to the SARS epidemic, the disputes regarding the performance of the contract shall be dealt with according to the specific circumstances by applying the principle of fairness..."

Dispute over right of recourse between Peiyan LI (the "Lessee") and Residents Committee of Xiguan District, Yonganlu Street, Laizhou City ("Xiguan RC" or the "Lessor"), according to judgment rendered by Yantai Intermediate People's Court with the reference number (2018) Lu 06 Min Zhong No. 268

In this dispute, the courts of first instance and second instance both held that:

"The SARS epidemic was an unforeseen calamity. Due to the epidemic, the appellant Peiyan LI had to suspend hotel operations and therefore suffered economic losses, which was an objective fact signed and confirmed by two members of Xiguan RC. Considering that the losses suffered by lessee exceeded the scope of market risk, we uphold the original ruling which ordered an appropriate reduction or partial exemption of the lease fee by applying the change in circumstances rule."

It should be noted, however, that the application of the change in circumstances rule is under strict control, according to the following judicial documents promulgated by the Supreme People's Court.

■ ***Circular of the Supreme People's Court on the Correct Application of Interpretations of Several Issues Concerning the Application of Contract Law of the People's Republic of China (II) to Serve the Overall Work of the Party and the State (Fa [2009] No. 165):***

"In order to adapt to the development and change in the economic situation and synchronize the legal effects and social effects of trial work, in accordance with the principles and spirit stipulated in the General Principles of Civil Law and the Contract Law, Article 26 of the Interpretations of Several Issues Concerning the Application of Contract Law of the People's Republic of China (II) provides that: where a party to a contract petitions the court to modify or rescind the contract on the grounds that the continued performance of the same is obviously unfair to the party or the purpose of the contract will not be realized due to occurrence of any material change in circumstances that is unforeseeable, not caused by force majeure, and not a commercial risk after the conclusion of the contract, the court shall decide whether the contract shall be modified or rescinded according to the principle of fairness on a case-by-case basis.

People's courts at all levels must correctly understand and carefully apply the above provisions. **If the application of the above provision is indeed necessary in a case according to the special circumstances of the case, the application of the rule should be examined by a high people's court. If necessary, the application of the above rule should be submitted to the Supreme People's Court for review.**"

Important Announcement

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