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FORCE MAJEURE

Issues for consideration by the European Financial Market Lawyers Group (EFMLG)

As stated in the Minutes, dated 10 April 2000, of the 3rd EFMLG meeting on 28 March 2000, the comparative study undertaken by the EFMLG has shown

- a wide range of diversity as regards the coverage of force majeure by statutory law, court decisions and provisions in market standard agreements, but
- common basic elements of the definitions developed by case law and
- a trend to address force majeure, and in particular impossibility and illegality, in standard market documentation.

Based on these findings, the Group has been invited to consider whether and, if so, in what areas of financial market business it is possible to develop an EU standard approach.

This paper lists and categorises relevant issues with a view to proposing further steps by the Group. As pointed out in the action points paper and the aide-mémoire, dated 4 October and 19 December 2000, of the 4th EFMLG meeting on 27 September 2000, the circulation of a questionnaire supplementing the one distributed in 1999 may be found appropriate. Items of particular interest, it was noted, could be strike, act of state, communication breakdowns and computer breakdowns, the last of these items to be seen in the light of the ECB's experience in the context of TARGET.

The context in which the concept of force majeure is relevant, as well as the respective legal consequences, can be quite different in the various EU jurisdictions. It can be procedural (e.g. interruption or extension of the period relevant for the statute of limitations or for the filing of a claim or brief in court) or substantive. The former type is probably of lesser interest to the work of the EFMLG. A substantive impact is typical in the following forms for the scenarios described below:

1. Discharge or suspension of obligations based on statutory concepts or court doctrines of frustration or impossibility

This kind of legal effect is typical and can be appropriate in relation to services (such as a plant construction) or deliveries of specific, non-fungible goods. For financial transactions, by contrast,

discharge or suspension alone would often not be the appropriate remedies. In the case of the borrowing of money, for example, the loan agreement would normally not provide that force majeure events preventing performance lead to a discharge of the borrower's obligations. Such events would be treated, instead, as a mere de facto hindrance, and they would normally allow the lender, as a legal matter, to require early repayment.

It is proposed that the EFMLG need not, at least not with priority, work towards a harmonisation of these statutory or court-developed concepts of force majeure because (i) this would be too ambitious, (ii) the Group's aim is, as a rule, harmonisation of market standards rather than rules of law, (iii) the legal consequences of a force majeure event provided in statutory or customary law would often be inapplicable to and/or inappropriate for financial transactions, and (iv) harmonising force majeure definitions in isolation, regardless of the legal consequences, does not appear to be meaningful.

This proposed conclusion should be reviewed and discussed with a view also to possible communication or computer breakdowns affecting settlement and payment systems, such as TARGET, or their participants. The question is, if these issues need to be addressed, whether dealing with them in the operating terms of the system(s) would not be more efficient than attempting to harmonise the applicable rules of law in the participants' countries.

2. Market-related force-majeure provisions in the underwriting business

Standard provisions in subscription agreements, e.g. in the form recommended by the International Primary Market Association (IPMA), provide a right to withdraw the transaction prior to closing in defined cases of force majeure. The concept of force majeure or supervening event triggering this right is comparatively broad. It typically encompasses not only illegality and impossibility, but also other unexpected major events which have a substantial impact on market prices, and thus make it unlikely that the securities offered can be sold at or near the price levels envisaged. This approach thus has elements of a commercial fairness test, combined with an effort to protect the underwriters' reputation and, to a degree, third parties (the investors).

It is not proposed to make harmonisation efforts in respect of this business segment and type of contractual provision either. This is primarily because IPMA has already achieved a remarkable harmonisation and transparency in this area, and also because underwriting commitments constitute peculiar risks (high impact, short term) with their own special rules which are not applicable to most other business activities.

3. Termination and close-out in the context of trading master agreements

In the trading and derivatives area, market participants' views were split until recently as to whether a broader force majeure clause, addressing also impossibility and "impracticality" in addition to illegality was appropriate, but some actual events like those which occurred in Indonesia and Malaysia seem to have sufficiently demonstrated the advisability of such clauses (encompassing factual hindrances and delays which result from force majeure). One aspect that has been identified is that in the absence of such a broader force majeure clause, an impossibility event will generally result in an event of default, the effect of which would be undesirable; in particular, the affected party would not be able to terminate (otherwise than in case of illegality) and the non-affected party would be able only to terminate all transactions (whether or not affected by the force majeure event) or none. What is worthwhile noting is also that a concept of impracticality, which is broader than impossibility, is likely to be introduced in future agreements.

The documents concerning Force Majeure Event provisions for the foreign exchange master agreements called IFEMA, ICOM and FEOMA, published by the Foreign Exchange Committee in New York in December 1999, were circulated to the EFMLG by the ECB in early January 2000. In essence (and disregarding some further refinements), the provisions state that if a Force Majeure Event occurs, and a Waiting Period of three Business Days has expired, either Party may terminate any Affected Transaction and the unaffected Party calculates the close-out amount; during the Waiting Period performance is deferred until the first Business Day after that period, and a reasonable amount is due to compensate for that deferral. The term Force Majeure Event comprises illegality, impossibility and, if caused by force majeure or act of state, the inability of or delay by a party to perform. "Force majeure" and "act of state" are not defined.

The proposed Illegality and Force Majeure provisions developed by the International Swaps and Derivatives Association (ISDA) for standard ISDA documentation are broadly similar to the approach chosen in respect of IFEMA/ICOM/FEOMA. Some differences in detail exist in that, for example, an Illegality and a Force Majeure Event are treated as distinct concepts, the Waiting Period is three Business Days in the case of Illegality and eight in the case of a Force Majeure Event, and the clause is to cover also impracticality of performance in addition to impossibility. The revised provisions are to become regular parts of ISDA Master Agreements (and will be capable of being adopted for outstanding ones by way of adhering to a "Protocol"); they are not, for future agreements, structured as "opt-in" provisions.

It is proposed that the EFMLG consider whether the approach taken by ISDA is to be recommended also for other market standard agreements, including the European Master Agreement and derivatives master agreements used in EU member states. (It should be noted that the EMA, unlike most other market standard agreements at the time when the EMA was set up, already deals with force majeure events in the form of an impossibility clause, which, however, is an "opt-in" provision.)

If the Group's reaction to this proposal is positive in principle, further materials will be circulated, including a supplementary questionnaire.

4. Political risk ring-fencing

Related to the issue of force majeure (and illegality) is the question of whether a party acting through a foreign branch as booking office is liable to perform through any of its other offices (especially its head office) if performance through the booking office is unlawful or impossible. US Federal and New York State banking legislation contain provisions excluding head office liability of US banks (or banks located in the State of New York, respectively) in such cases. Comparable statutory provisions can be rarely found (if at all) in the laws of other jurisdictions.

The question which the EFMLG may wish to consider is whether clauses limiting head office liability in the case of force majeure/political risk events in the branch country, and achieving effects similar – though only in respect of the transactions in question – to those of the US and New York statutes mentioned above are appropriate. One view can be that a legal entity should always be fully responsible for all its branches, regardless of whether non-performance through the branch is caused by credit (solvency) factors or political/force majeure events. Another possible view is that a counterparty which has chosen to transact with a branch in a specific (possibly high-risk) jurisdiction, rather than with the head office, should be treated as having implicitly assumed the risks peculiar to that jurisdiction.

These issues have been considered recently by an ISDA working group. The likely outcome is that ISDA will not take any particular position in this regard, but will regard this as a matter of policy for each institution, and for bilateral negotiation.

The EFMLG may wish to discuss this aspect of the force majeure topic, too, explore views of its members and conclude whether it intends to make a recommendation or consider this as a business policy matter and remain neutral.

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