MEMORANDUM REGARDING PROPOSED DEFINITION OF "FORCE MAJEURE EVENT"

The Global Documentation Steering Committee (the "Committee") has prepared a uniform definition of "Force Majeure Event" for use in financial market transactions. The definition, set out in Attachment A, seeks to provide a common framework for market participants in invoking appropriate termination and similar contractual provisions upon the occurrence of such an event.

Background

A number of developments in recent years, including in particular the severe market disruptions of 1998, have prompted renewed interest in the issue of "force majeure" and similar clauses in financial market contracts. In June 1999, for example, the Counterparty Risk Management Policy Group recommended that financial market trade associations develop and implement contractual provisions to address the consequences of "Acts of God" and "impossibility." In addition, in December 1999, the Foreign Exchange Committee of the Federal Reserve Bank of New York, in response to a study by the Financial Markets Lawyers Group, published recommended revisions to replace the Force Majeure, Act of State, Illegality and Impossibility Section of its ICOM, IFEMA and FEOMA agreements. In light of these concerns and efforts, the Committee determined to develop a uniform "force majeure" definition for use in standardized contracts of financial market industry trade associations.

"Force Majeure" in Financial Market Contracts

Legal precedent addressing "force majeure" and related doctrines varies substantially from jurisdiction to jurisdiction. Broadly speaking, however, many jurisdictions recognize the potential for certain events, generally unforeseen and outside the control of the parties, to modify or excuse the performance obligations of the parties under otherwise valid and enforceable contracts.

In the context of financial market contracts, the Committee considered it essential, as a threshold matter, to adopt the view that the occurrence of a traditional "force majeure" event

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generally should not constitute an excuse from performance. The definitive allocation of risk with respect to various market events is a critical element of financial market contracts and the occurrence of unforeseen events, even when outside the control of the parties, should not enable one party to deprive the other of the benefit of its bargain.

Nevertheless, financial market participants have an important interest in establishing a clear framework, in appropriate cases, for effecting early termination of transactions when a force majeure event has occurred, as well as for establishing a mechanism for determining the amount of the parties’ remaining obligations upon the occurrence of such an event. Accordingly, the Committee undertook to prepare a uniform definition of “Force Majeure Event” that would capture the types of events that, while not constituting an excuse from performance, ordinarily should trigger early termination of a financial market transaction and application of an appropriate contractual methodology for determining the remaining obligations owed by the parties.

The choice of an appropriate methodology for calculation of the parties’ obligations upon the occurrence of a “Force Majeure Event,” however, raises issues that the Committee has not yet fully considered and that may depend significantly on the nature of the underlying financial market transaction. The Committee thus has not adopted at this time a specific termination formula (e.g., mid-market pricing) or methodology for determining the contractual amounts that would be owed upon the occurrence of such an event.

In addition, in some categories of transactions (e.g., repurchase agreements), market participants may not consider it feasible or desirable to develop a contractual provision addressing force majeure events separately from other performance defaults. In such cases, each party’s obligations would be viewed, notwithstanding the occurrence of a force majeure event, as continuing fully in force in accordance with the transaction’s original terms, and failure to perform would be addressed under standard default remedies otherwise provided in the contract.

**Proposed Definition of “Force Majeure Event”**

The definition of “Force Majeure Event” proposed by the Committee seeks to build on the existing definition promulgated by the Foreign Exchange Committee and materials under consideration by industry trade associations such as ISDA. The definition encompasses two broad categories of events: those that preclude performance as a result of force majeure or act of state, and those that would render performance illegal. The Committee, consistent with the approach taken by the Foreign Exchange Committee, did not attempt to define explicitly the term “force majeure” in light of the need for flexibility in addressing an inherently unforeseeable category of events. The definition of “Force Majeure Event,” however, makes explicit that, other than in the context of illegality, (i) the event or circumstance must be beyond the control of the affected party and (ii) the affected party must have taken precautions commonly adopted by

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3 The Committee’s definition is not intended to address the treatment of unanticipated changes in tax laws or regulatory regimes (e.g., ERISA) that may have consequence for the parties short of actually rendering performance illegal, a topic more appropriately covered under specific tax or other provisions in standard industry documents or individualized agreements negotiated between the parties.
financial market participants to anticipate, and must be unable with reasonable diligence to overcome, such event or circumstance.

The Committee reviewed a number of potential scenarios in which a “Force Majeure Event” could affect the ability of a party to perform its obligations in a financial market transaction. In analyzing these scenarios, a variety of complex questions arose regarding how the definition should apply in cases where the occurrence of a current “force majeure” event could prevent future performance due under a transaction.

The Committee did not wish to create uncertainty or an inappropriately low threshold by proposing a wholly “anticipatory” approach to these questions (e.g., a definition that would allow a party to make a subjective determination that the other party would be prevented from performing in the future even where the “Force Majeure Event” had not yet occurred). At the same time, the Committee did not consider it feasible to adopt a wholly formulaic test that would require the parties either, on the one hand, to wait until the actual performance date before making a determination or, on the other hand, to assume that all performance, even in the distant future, had been accelerated to the present.

The Committee thus drafted the definition to include those “force majeure” events by virtue of which a party “is or would be” prevented from performing its obligations on a timely basis in respect of a transaction, as set out in Attachment A. This standard is intended to provide an objective test, yet to allow the definition to be triggered even prior to the expected date of performance once the force majeure or other event has occurred. For example, if a government were to impose an indefinite payment freeze, effective at the opening of the next business day, in circumstances where payment is not required to occur for thirty days, then the future payment “is or would be” prevented within the meaning of the proposed definition.4

Notice and Termination

The Committee generally expects, as noted above, that the occurrence of a “Force Majeure Event” would trigger termination of a transaction and application of an appropriate contractual methodology for determining the parties’ remaining obligations (e.g., a mid-market termination provision or similar remedy), except in the case of those categories of transactions for which market convention dictates that the parties’ contractual obligations would remain fully in force and unaffected by the occurrence of such an event.5

The Committee anticipates that financial market trade associations and market participants would develop appropriate notice periods for application of any such termination or

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4 In some cases, a market participant may be concerned that a force majeure or similar event could disrupt the market in which it must effect hedges relating to a transaction with a counterparty, even where the event might not preclude performance by the counterparty of the transaction itself. In such cases, a party may wish to adopt specific contractual provisions designed to address the impact of events in the market in which hedges occur, either as part of a force majeure clause or as part of a more general clause regarding events affecting the party’s ability to effect hedges.

5 The Committee recognizes that there may be specific categories of events (e.g., certain market disruptions) for which parties may wish to specify “fallback” remedies other than termination of a transaction.
similar provisions. In some cases, it may be desirable to establish a different notice period for events covered by the first clause of the proposed definition (relating to force majeure) than for events covered by the second clause of the definition (relating to illegality). Trade associations with agreements containing credit support provisions also would be expected to tailor those provisions to address the occurrence of a “Force Majeure Event.”

An important element of termination provisions arising in the context of a “Force Majeure Event” would be the ability to limit the application of those provisions, on a trade-by-trade basis, to transactions directly affected by the event. This trade-by-trade approach is intended to foreclose the ability of a party inappropriately to use the occurrence of a Force Majeure Event to trigger early termination of unaffected transactions.

In addition, in the case of trade associations that consider it inappropriate to provide any mid-market or other termination formula specifically to address “Force Majeure Events,” it may be desirable to confirm, in the context of guidance notes or otherwise, that existing standard agreements would be expected to be performed in accordance with their terms, regardless of the occurrence of such an event.
Force Majeure Definition:

"Force Majeure Event" shall mean, on any date, that:

(a) a party, by reason of force majeure or act of state, is or would be prevented from complying with, or it is or would be impossible or impracticable to comply with, any material provision of this Agreement relating to a Transaction (but only where (i) such event or circumstance is beyond the control of the affected party and (ii) such party has taken precautions commonly adopted by financial market participants to anticipate, and cannot with reasonable diligence overcome, such event or circumstance); or

(b) it is or would be unlawful for a party to comply with any material provision of this Agreement relating to a Transaction.

For purposes of this definition, it is acknowledged and agreed that the failure to make or receive a payment or delivery on a timely basis in respect of a Transaction shall constitute a failure to comply with a material provision of this Agreement.