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Force Majeure in Project Finance: *A Comparative and Practical Analysis of Risk Allocation*

KFIR MIZRACHI

KFIR MIZRACHI
is an advocate and a member of the Israeli Law Bar.

RISK MITIGATION IN PROJECT FINANCE: BETWEEN BUSINESS CONCERN TO LEGAL SIGNIFICANCE

The success of a project finance transaction often depends upon the way business practitioners mitigate the various risks inherent in the project.[1] In the process of allocating risks, a special concern is given to economic aspects of the transaction, sometimes on account of the legal ones. However, upon litigation or materialization of the various risks, the legal aspects are those that, de facto, play the main role in allocating such risks. In the following article, I will discuss one of the important risks in a project finance transaction—the risk of a force majeure event—and comment on its legal doctrines and effects from a comparative and practical point of view.

1. INTRODUCTION

The project finance technique for financing infrastructure projects in developing countries has become a major and attractive way of financing in the last 30 years both for those developing countries and foreign investors. As in any financing project, its foundation, and later its success, is based on a contract among the parties to the transaction. The very foundation of project finance in that sense requires a different, or special and specific attitude to its very contractual terms. Project finance in its inherent structure—as a debt finance technique where lenders rely primarily on the cash flow produced by the project to service their loan rather than on other sources of payment[2]—along with the fact that the transaction takes place mostly in developing countries that are subject to an unstable environment, requires special attention while drafting the project agreement. In that connection, *force majeure* events pose a major risk to the success of the project. The fact that the parties to the transaction are generally from different countries, with different legal systems and contract law, requires the drafters of the project agreement for a specific concern to focus on comparative legal issues.

In the following article, I will analyze the doctrines of *force majeure* and their consequences from a comparative and practical point of view with a specific connection to the characteristics of a project finance transaction. The article will go through: 1) the necessary definitions of project finance and *force majeure* events and applicable doctrines; 2) a comparative discussion of the above doctrines among different legal systems, different countries within systems, different modern global codifications, and different theoretical approaches to the analysis of contract law; and 3) a practical discussion concerning the mechanisms of risk mitigation, insurance, and practical advice for drafting *force majeure* clauses.

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1.1 Basic Principles of Project Finance Transaction

Project finance is a nonrecourse or limited recourse financing structure where debt, equity, and credit enhancement are combined for the construction and operation of a particular facility in a capital-intensive industry, where lenders base credit appraisals on the projected revenues from the operation of the facility itself,[3] rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt.[4]

Project finance that focuses on infrastructure projects in developing countries is an attractive technique of finance for both investors and developing countries.[5] While the investors look to maximize their profit, the countries are looking for the resulting project and public services that the government itself was supposed to provide (services such as sewer systems, public electricity, telecommunication service, oil and gas, transportation and roads, and natural resources such as copper mines and gold mines).[6]

Historically, the obligation to provide such services fell upon the government itself, which financed the services through public funds and tax revenues—all as public goods that should have been provided with the mandate of the welfare state.[7] However, lack of funds, fiscal deficits, and increasing financial instability resulted in stagnating rates of economic growth and created a need for foreign private investors to fill this gap.[8]

Practically, the sponsors of the project—the investors—form a separate entity called the project company, which is owned and managed by the sponsors. The project company itself is the entity that borrows the funds for the project in a structure that normally does not have a direct effect on the balance sheet of the sponsor/investor. In that structure if the project fails, the only assets the lender can reach are the project assets; the lender does not have recourse to the parent company.[9] The project company is expected to repay the loan, and to make a profit from the project's operating cash flaw, while obtaining guarantees from the host government to assure that the project will progress smoothly.[10] However, aside from the above advantages, a project finance transaction presents inherent risk factors that should be carefully considered and mitigated while the project agreement is being drafted.

1.2 *Force Majeure* and Applicable Doctrines

What is force majeure?

The rule of *force majeure* and its applicable doctrines are in fact an exception to the basic principle in contract law known as *pacta sunt servanda* (promises should perform and enforce).[11] *Force majeure* is defined as a loss that results from a natural cause without the intervention of man, which could not have been prevented by the exercise of prudence, diligence, and care.[12] *Force majeure* clauses define the circumstances sufficient to excuse performance under the contract and the degree to which those circumstances must interfere with performance.[13]

Events within the scope of *force majeure* are: Acts of God (earthquake, lightning, flood, fire, storm, and crop failure); events relating to social and/or political circumstances (war, revolution, riot, coup, and strike); legal events (seizure of goods, embargo, prohibition of the transfer of foreign funds, and prohibition or restriction of foreign imports and/or exports);[14] and other events (loss of the carrying vessel, theft, robbery or sabotage during storage or carriage, general strike, and general power supply cut).[15] The occurrence of any of the aforesaid events may 1) destroy the project's premises or factory; 2) prevent the seller, the carrier, or the warehouse operator from delivering the goods; 3) cause damage to or total or partial loss of the goods, or 4) prevent the buyer from paying the price upon the agreement.[16]

The level of impossibility and applicable doctrines. *Force majeure* events can result in absolute impossibility to perform or in a fundamental change in circumstances that results in a different-than-expected outcome as well as an economic burden for the parties concerned. The line between those two cases is not always readily apparent or easy to distinguish.[17] Hence, *force majeure* events can be examined under several doctrines that differ according to whether the legal system recognizes such events as sufficient basis for excuse from performance. The doctrines can be divided into two main groups according to the level of impossibility to perform. Doctrines regarding fundamental impossibility are: frustration and *force majeure*. Doctrines regarding change in circumstances resulting in extra burden to perform are: commercial impracticability, hardship, and *Imprévision*. Some legal systems discuss both levels of events under the same doctrine (e.g., English and Israeli laws), while others designate a separate doctrine for each event (e.g., French law, Unidroit, and the EU principles of contract law). Thus, from a comparative and practical point of view, regarding international transac-

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tions, it is important to stand upon the merits of the various doctrines and their legal consequences.

2. COMPARATIVE DISCUSSION: SUBSTANTIAL LAW

"In comparative law, there are many situations where the same legal term has different meaning or where different legal terms have same legal effect."[18]

2.1 The Importance of Comparative Analysis in Project Finance Discussion

Project finance transactions are characterized in two ways that emphasize the importance of a comparative discussion of provisions of *force majeure*. First, project finance transactions are mainly long-term transactions that make it more difficult for the parties to anticipate in detail any future event that will render it impossible to perform.[19] Second, project finance transactions are mainly international transactions that inherently are subject to friction between laws of two different countries, and more often, between two legal systems. Hence, because the doctrine of excuse is not uniform across the globe, parties to a project finance transaction should give crucial notice to *force majeure* provisions, their terminology, and their consequences.[20]

While there are many issues that are dealt with in the same way by the civil law and the common law systems, there remain also significant differences between those two legal systems related to legal structure, classification, fundamental concepts, and terminology.[21] One of those differences concerns the way each of the legal systems deals with the issue of impossibility of performance of contractual obligation. While all legal systems recognize, in a way, excuse when it is impossible to perform, the degree of protection they grant may vary depending on which country's law governs the contract.[22] Moreover, the growing globalization of the world economy, based on closer integration and cooperation among states, has imposed a need for legal certainty and unification of law that will be applicable in international commercial transactions.[23]

2.2 Freedom of Contract and the Relevancy of the Substantial Discussion

"Force majeure clauses are a reflection of parties' freedom of contract... regarding risk allocation."[24]

The doctrine of *force majeure* and impossibility in all legal systems can be waived.[25] Thus, the parties to a contract can freely define or enumerate the events that will excuse performance and to stipulate the consequences of such events.[26] The parties may, as a result, either expand, limit, or eliminate the defense of *force majeure* that would apply in the absence of a contractual provision as part of their right of freedom of contract. From a theoretical point of view, the relevance of the various doctrines regarding *force majeure* and impossibility of a party to perform refers to the situation of impossibility to perform where the parties have not agreed within the contract upon the scope and consequences of such event. Thus, upon such event, each legal system as well as other theoretical approaches (economic approach and moral approach) search for a just and efficient rule to fill the contractual gap. Furthermore, the function of the law in such cases, and especially in long-term contracts that characterize project finance transactions, is to reduce the costs of transactions by providing a standard set of terms, against which background the parties can contract.[27] In the following section, I will discuss the various rules adopted by each of the legal systems and theories and assess their justification and efficiency from a comparative point of view.

2.3 Certainty, Efficiency and Foreseeability

There are two main interests regarding the determination of whether to exempt performance of a contractual party from the occurrence of an unforeseeable event: certainty and efficiency. A rule that recognizes exemption from performance in unforeseeable events requires an *ex post* determination whether the risk was foreseeable and who should have born it in a case where the contractual parties did not allocate the risk in the agreement. Hence, a vague rule to fill such gap in the contract will result in uncertainty, and thus will harm the interests of both the contractual parties.[28] That approach, argued by *Kull*, describes the desirable rule for exemption from nonperformance as a "windfall rule." According to that rule, a risk that was not allocated by the parties in the agreement should not be allocated by external intervention of the court according to the bargain theory, because there is nothing in the bargain itself that indicates how the risk should be allocated.[29]

On the other hand, absence of exemption from performance in occurrence of unforeseeable events will result in ineffectiveness. Such approach would have required

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the parties to negotiate a lot of scenarios that are not necessarily expected to occur.[30]

Furthermore, ignoring the limits for the ability of the parties to foresee events in detail will also result in unjustified results.[31] In the following paragraphs, I will analyze how different legal systems have dealt with the problem of exemption from performance in occurrence of unforeseeable events while keeping in mind the necessity of balance between certainty and efficiency.

2.4 Common Law

Common law has evolved in England since the eleventh century and was later adopted in the United States and other countries of the British Commonwealth such as Israel, Canada, and Australia.[32] The common law mostly differs from the civil law by the fact that the common law development is mainly based on case law.[33] The common law dealing with *force majeure* and all other circumstances places impossibility under the doctrine of frustration.[34] The common law's general approach is strictly to deny excuse from performance in such cases.

(a) English Law

Traditionally the English common law has denied, in principle, that impossibility excuses performance of a contract according to the rule of *pacta sunt sevanda.*[35] The doctrine upon *force majeure* circumstances examined by the common law is frustration, which is broader than the doctrine of *force majeure* in the civil law[36] and contains no requirement for absence of fault from the nonperformance party.[37] The origin of the rigid exemption rule of frustration emerges in the case of *Paradine v. Jane*,[38] in which a tenant, evicted by Prince Rupert's army from the land he had leased, was held to be liable for rent. The *Paradine* court held that "where the party by his own contract creates a duty upon himself, he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract."[39]

The doctrine was then established by two major cases: *Taylor v. Caldwell*[40] and *Krell v. Henry*.[41]

Taylor involves the lease of a music hall for the use of several concerts by the lessor. However, six days before the first concert, the hall was destroyed by fire. Accordingly, the court held that since the existence of the hall was essential to the performance of both parties, when it perished both parties were excused from their respective obligations.[42]

By the beginning of the twentieth century, the following excuses for impossibility of performance existed: 1) unavailability of a specific person or thing necessary for performance, 2) supervening domestic illegality or other governmental interference, 3) contractual excuse clause, 4) fault of a party, and 5) temporary delay likely to last for more than a reasonable time.[43]

The *Krell* case enhanced that development. The case involved the coronation procession for Edward VII. Rents were sold to see the procession. However, the procession was not held because of Edward's illness.[44] The *Krell* Court expanded the *Taylor* principle so that it applied not only when a specific person or thing necessary for performance became unavailable, but also when any condition or state of facts basic to the contract ceased or failed to occur.[45]

Under English law, the doctrine of frustration wholly discharges the contract and both parties from their contractual obligations. The general approach is that the obligor is either completely discharged or must completely perform his contractual duties. For example, the English common law gives the judge absolutely no power to alter legal rights with respect to a concluded contract.[46] As for *pro rata* performance, English case law has not developed any fixed precedent.[47] However, in *Tenants Ltd. v. Wilson & Co. Ltd.*,[48] the court allowed a *pro rata* to be effected, arguing that the seller was either obligated to all of his contracting partners in the same way or obligated to none of them.[49]

The rules for recovery under the English law are set under the Law Reform (Frustrated Contracts) Act 1943,[50] which modifies the common law doctrine of frustration.[51] The Act's main purpose was to avoid the unjust enrichment of one of the parties in a case of frustration providing adjustment in recovery.[52] As for the right for restitution, the parties can keep the benefits already received as well as maintain their claims to obligations which became due before the frustration and recover from advanced payments.[53]

(b) American Law

(i) Commercial Impracticability

American law deals with *force majeure*, impossibility, and frustration under article 2-615 of the Uniform Commercial Code (UCC). However, article 2-615 generally refers to the doctrine of commercial impracticability. Under the doctrine, a party's obligation to perform can be excused where unforeseen obstacles render performance impracticable, impossible, or frustrate the purpose of the contract.[54]

Article 2-615 limits its application in two manners: 1) the article provides an excuse only for sellers, and

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2) excuses can arise only to nonperformance of delayed in delivery or nondelivery.[55] However, according to *Lookofsky*, comment 9 to article 2-615 provides a place for excuse from performance also to the buyer in situations of assumptions and allocation of a relevant risk.[56]

Article 2-615 provides that to successfully raise excuse from performance, the seller must establish that 1) an unexpected event or a "contingency" occurred, 2) the nonoccurrence of the contingency was a basic assumption of the contract, and 3) the occurrence rendered performance impracticable.[57]

The article does not include a list of circumstances that can raise or limit the applicability of the doctrine. However, the comments to the article provide us with some guidance.

Comment 4 states that "increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance."[58] In addition, market changes will not result in excuse from performance in long-term contracts, under the assumption that such change was allocated by the long-term agreement.[59] Yet, a severe shortage of raw materials or of supplies due to a contingency such as war or embargo could render performance impracticable.[60] The prong of foreseeability under article 2-615 requires that the nonoccurrence of a contingency be a "basic assumption" of the contract, and hence was allocated by the parties by the contract.[61]

Comment 8 to article 2-615 provides a rule of greater liability by agreement, which will not excuse performance where a seller assumed the risk of the event.[62] The determination upon such greater liability can be found "not only in the expressed terms of the contract but in the circumstances surrounding the contracting, in trade usage and the like."[63] In the absence of other provision by contract, the seller has a duty to follow some procedures such as notifying the buyer of a delay or nondelivery and allocating his production fairly among customers in a reasonable manner.[64]

(ii) *Force Majeure* within the Doctrine of Commercial Impracticability

According to article 2-615, the seller is only automatically excused in a *force majeure* event if there was such a provision that came to pass. *Force majeure* clauses provide a specific, negotiated framework that courts can use when applying the doctrine of excuse.[65] To invoke a *force majeure* clause, a party must establish that the excusing event 1) actually prevented performance and 2) was not reasonably within the control of the nonperforming party.[66]

The question of whether an event was under the control of the party depends on how the parties draft the *force majeure* clause. In *PPG Industries, Inc. v. Shell Oil Company*[67] the court held upon the realization of *force majeure* clause that Art. 2-615 did not impose a control requirement on *force majeure* clauses,[68] and since the clause did not explicitly state that an explosion must be beyond the party's control to excuse performance, the court refused to impute such a restriction.[69]

Article 2-615 does not make any express provision for the legal effects.[70] However, in a case of significant impossibility, the contract will be terminated. According to Comment 6, the article does not exclude the possibility of adjustment of the contract by the court where "neither sense nor justice is served by either answer when the issue is posed in flat terms of excuse or no excuse—especially the sections on good faith."[71]

The court exercised such power in *Aluminum Co. of America v. Essex Group, Inc.*[72] In *Aluminum*, the price of crude oil was increased by 500%. Although the court recognized the existence of *force majeure* situation, it refused to terminate the contract and held that the completion of a long-term contract required a careful examination of the contract, the intent of the parties, and supervening event. Under that examination the court held that an adjustment was the suitable legal remedy since it came closest to the intentions of the parties and avoided inequities.[73]

According to Article 2-615(b), if the causes affect only part of the ability to perform, the seller must allocate production and deliveries among his customers in any fair and reasonable manner.[74] Restatement (Second) of Contracts § 377 (1981) provides restitution upon termination of contract in cases of frustration or commercial impracticability: "A party whose duty of performance does not arise or is discharged as a result of impracticability of performance, frustration of purpose... is entitled to restitution for any benefit that he has conferred on the other party."[75] In *Butterfield v. Byron*,[76] the court held that "defendant can recover for work done and material furnished on an implied assumption at the contract rate."[77] Yet, while recovery of damages effected in advance is allowed, recovery of loss for reliance on promise to perform is not permitted.[78]

(c) Israeli Law

(i) Between Common Law and Civil Law

"The Israeli legal system of law is generally described in Israeli legal literature as a mixed system of law."[79]

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The Israeli legal system is known as a mixture of common law and civil law. Prof. Rabello, in a significant article regarding the history and sources of the Israeli legal system, presented that evolution and history.[80] With the establishment of the state of Israel, the Israeli government adopted the British common law that governed in the state of Israel during the British Mandatory. The law that was adopted was full of gaps, which were filled during the first years from the English common law and by Israeli development of origin case law. However, there was a need to fill the gaps also with a substantial amount of civil legislation. The massive legislation led to wide discretion for the court to interpret the new code and helped to establish a profound tradition of Israeli common law.[81] In contract law, the codification provided the scope of European Civil codes, but the solutions adopted and the underlying principles that were followed reflected the influence from both common law and continental law.[82]

(ii) Frustration

Force majeure exemption discussed under Article 18 of Israeli contract law (Remedies for Breach of Contract),[83] under the title "Exemption by Reason of Constraint or Frustration." The claim for frustration in Article 18 is a claim of defense that can be raised only by the party that could not perform his contractual obligation owing to fundamental impossibility and cannot be raised by the other party.[84]

The doctrine of frustration in Israeli law, as well as in English common law, is broader then the concept of *force majeure* in civil law and comprises within it also the doctrines of commercial impracticability or hardship. Thus, Article 18 of Israeli contract law provides for two sets of circumstances (impossibility to perform and change of circumstances) the same consequences,[85] as stated by the statute: "performance of the contract under these circumstances is *impossible or fundamentally different* from what was agreed."[86] (emphasis added—K.M.) Both scenarios (impossibility and change of circumstances) are examined under the same standard. The standard provides that exemption from one of the above will be granted in the occurrence of impossibility to perform due to an unexpected and unforeseeable event at the time of making the contract that could not be avoided by the nonperformance party.[87]

In practice, the Israeli courts gave a very narrow interpretation and application of Article 18 under the assumption that there is nothing that is unforeseeable.[88] Even events of war,[89] severe climate changes,[90] strikes,[91] and severe currency changes were not considered as unforeseeable events.[92] For example, in *Bloomfeld v. Hadar Plast Ltd.*,[93] where impossibility was due to the breakout of the Yom Kippur war, it was held that "just very extreme circumstances will justify the use of Article 18 (frustration) and the outbreak of a war does not constitute such circumstances."[94] The approach of the Israeli courts is so strict that scholars regard Article 18 as a "dead letter."[95]

However, in recent years we can see a transformation in the court approach from foreseeability to a softened foreseeability standard, and to an approach of risk allocation.[96] Such an approach was at the main issue in the *Regev* Case, where the outbreak of the Gulf War in 1990 was regarded as a foreseeable event.[97] The *Regev* Court noted that the fact that war is a foreseeable event in the Middle East does not lead to a conclusion that any frustration to perform is foreseeable. The foreseeable test should apply not to the event itself but to the consequences of such event on the agreement.[98]

The risk-allocation approach provided that the decision as to which party will bear a given risk should be decided on the basis of the contract and the circumstances in which it was drafted, under the presumption that we should respect the allocation decided by the parties themselves.[99] Hence, a rule that will not respect such allocation made by the parties will result in unjustified enrichment of one of the parties.[100]

The Israeli courts' strict approach is also exemplified in the requirement of Article 18 that the nonperforming party *could not avoid* the unforeseeable event. The court required not only that the party could not avoid the event but also that the party could not prevent the event itself from causing impossibility to perform.[101] For example, the court denied a claim for nonperformance where a party did not make arrangements to find substitute employees when he knew ahead that a closure of the Gaza strip would occur upon national security tension,[102] or where a strike occurred that was the fault of the employer, who refused to pay justified demands to his employees and did not take active steps to resolve the strike as soon as possible.[103] However, a party is not required to relentlessly prevent such an event if the costs to take such measures are extremely unreasonable.[104]

The consequences of successful claim for exemption from performance under article 18, are that "the breach shall not give cause for *enforcement* of the contract or for *compensation*" (emphasis added—K.M.). According to the article, the injured party is deprived of the remedy

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of specific performance and damages.[105] However, the court has, according to article 18(b), discretion whether to grant restitution or indemnify the other party for relying expanses whether the contract was terminated.[106]

The inherent meaning of such provision render some important assumptions that differ from the Anglo-American approach: 1) the frustration event does not render termination of the contract nor the fact that breach of contract occurred; 2) exemption to perform does not automatically grant either party the right to terminate the contract; and 3) exemption to perform, by itself, does not establish a cause of action to enforce adjustment of the contractual obligation to the new circumstances.[107] Application of such approach was established in *Elram Housing project Co. v. Padan*,[108] where the court held that "claim for frustration is a 'defense claim' of the party who breached the contract, rather than a 'sword claim' of the party who harmed from that breach."[109]

American law in contrast provides under article 2-615 that the failure to perform should not render a breach of contract, and that the obligation to perform is automatically discharged (Restatement (Second) of Contracts (1979) §261).

The idea that Article 18 provides the same remedies for both impossibility and change-of-circumstances events was criticized by Israeli scholars. According to Ben-Oliel, positive formulation providing a way to preserve the contract is preferable in a case of change of circumstances rather than a negative one denying enforcement and damages.[110] According to Sanilevici, in the case of change of circumstances, the remedy creates a major imbalance between the parties and it does not provide a solution to change the condition of the contract consensually by the parties or by the court.[111]

However, the Israeli courts more than often provide such intervention in the contract as a direct result of the approach not to recognize an event as unforeseeable. The intervention approach is taking place in situation of change in circumstances rather than in cases of impossibility.[112] Such an approach took place for the first time in the case of *Ata Textile Co. v. Zolotolov*.[113] In *Ata*, an agent of the company needed to give a deposit to the company to sell its goods. According to the agreement, the deposit should be returned to the agent upon termination of the contract. Twenty years later, upon termination of the contract, it was in dispute whether the deposit should be returned in its nominal value or its real value, because the change in currency in that time was enormous. The court interfered with the contract by means of interpretation of the hypothetical intent of the parties and decided that if such a situation was before the parties at the time they were negotiating the contract, it is reasonable to assume that they would have agreed to allocate the risk in real value.[114] In a later case *Machtzevot Haifa v. Chan Ron*,[115] the court intervened with the contract by means of the theory of good faith and set the general rule for situation of change of circumstances while stating that "in principle the court may intervene in the event of a fundamental change of the conditions of performance of the contract, as for instance in the case of an unexpectedly high inflation leading to the breakdown of the contractual balance."[116]

The doctrine was finally established in the case of *The State of Israel v. Apropim Constructions & Housing Co. (1991) Ltd.*,[117] where the court held that "the doctrine of good faith is not limited only to the manner in which contractual obligations should be performed, but also is a source to add contractual obligations to an existing contract."[118]

That approach is also close to the American law doctrine of substantial performance, provided that "substantial performance rather than exact, strict or literal performance by the first party of the terms of the contract is adequate to entitle the party to recover on it."[119] The significance of such approach is in the context of long-term contracts, which are characterized by a special relationship between the contractual parties.[120]

According to Israeli law, it seems that any factual case of *force majeure*, such as strike, war, terror action, or natural disaster, will not be deemed as an event that the parties could not foresee. According to Israeli law everything is foreseen. Israeli law does not provide a distinction between situations of *force majeure* and hardship or commercial impracticability, but discusses all under the doctrine of frustration. Although the Israeli courts will mostly not recognize such excuses for performance, the Israeli case law has dealt with those problems by means of various methods such as good-faith performance, interpretation of contract, and by moving toward a risk-allocation approach alongside the requirement of foreseeability.

2.5 Civil Law

Civil law has its origin in Roman law, as codified in the *Corpus Iuris Civilis* of *Justinian*, and has developed mainly in continental Europe.[121] Civil law deals mainly with impossibility to perform under two different doctrines: *force majeure* and fundamental change in circumstances. The civil law general approach is to adjust the

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terms of the contract rather then automatically terminate it and discharge the contractual parties from their obligations.[122] Furthermore, the civil law approach regarding award of damages relates to the concept of fault in breach, while the common law approach is strict liability.[123]

(a) French Law

In French law, there are two doctrines regarding exemption from performance of contractual obligation. The two doctrines are *force majeure* (referring to fundamental impossibility to perform), and the doctrine of *Imprévision* (referring to burdensome to perform and change of circumstances). The effects and provisions of each of the doctrines are different, as will be discussed next.

(i) *Force Majeure*

In French law, the doctrine governing events of impossibility of a party to perform its contractual obligations is the doctrine of *force majeure*.[124] French law recognizes *force majeure* as an outside cause beyond the control of the party that will release an obligor from his contractual duty, where the obligor shows no fault of his own.[125]

According to Article 1147 of the French Civil Code, unless the party has assumed the risk of impossibility, no liability is incurred for nonperformance if it is impossible to perform the contract owing to an event that the parties could not reasonably have been expected to foresee at the time the contract was concluded.[126]

The doctrine provides a strict standard composed of three requirements: the event was unforeseeable, unavoidable, and external. According to Kurkela, these requirements "merely establish that the obligor is without fault and therefore that the essence of the defense is the absence of fault."[127]

The application of the standard under French case law provides a rigid and strict approach, as argued by Dalloz: "the impossibility of execution must be absolute; even a serious difficulty is not a basis for exoneration and the debtor remains liable."[128] Accordingly, difficulties to perform due to events such as war, strike, increased price of product, and general change in the economy have not been taken into consideration.[129] In one case, it was held that the derailment of a train following an act of sabotage by workers during a strike was foreseeable.[130] As a result of that approach, the events rendering the performance impossible can neither be the result of an affirmative act of the party invoking the *force majeure* nor be imputable to him.[131]

The requirement of complete impossibility is strict as well. It is not enough to show that the contractual obligations have become more difficult or burdensome as a result of the event.[132] Application of that approach is presented in the case of *Miard v. Vacher*.[133] In *Miard*, an insurance company sought to declare a policy terminated as a consequence of substantially increased risk that resulted from the increase of draft quotas. The court held that "as the issuer would have benefited from a decrease in the risk... the change in question did not constitute a *force majeure*, in that it did not render impossible, but only more difficult, the performance."[134]

The immediate effect of successfully invoking *force majeure* defense is excuse from performance by the party that invokes such defense.[135] However, either party may seek to have the contract terminated by the court. The court may order that the contract be temporarily suspended, annulled retroactively or, if the contract cannot be suspended or annulled, terminated prospectively.[136] Accordingly, no damages or compensation are due for the losses or costs the parties may have suffered.[137] According to article 1183 of the French Civil Code, if the contract has been terminated, the parties are required to return any benefits they may have received under the contract including any advance payments.[138] There is no duty under French law for a party to inform the other party within a certain time of the occurrence of the *force majeure* event.[139]

(ii) *Imprévision*

The doctrine of *Imprévision* in the French law refers to cases where there was a fundamental change in the circumstances that turns performance burdensome. In contrast to the doctrine of *force majeure*, the doctrine of *Imprévision* refers to circumstances where performance is still possible.[140] The approach to *Imprévision* by French law is to forbid judges to annul or revise contracts on that ground whatever the consequences might be.

However, that approach is limited to cases where the unforeseen event causing the imbalance in the contract is economic or financial.[141] If the unforeseen event is of a kind different from price fluctuation, it is not called *Imprévision* and judges interpret the contract and introduce modifications in its arrangements.[142]

However, the doctrine of *Imprévision* is applicable under the French Administrative law rather than in the private law of contracts. In that field of law the doctrine is applicable where the government or other public body is a party to the contract.[143] According to the doctrine, the court is allowed to adapt a contract that has become extremely burdensome for one party owing to unexpected

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change in circumstances.

According to Horn, the applicability of the doctrine is significant for contracts in international business, particularly project finance transactions, because generally those contracts are concluded with governmental agencies.[144]

(b) German Law

Wegfall der Geschaftsgrundlage

The general approach of the German doctrine regarding *force majeure* cases is to avoid excuse from performance. Under German law, not every destruction of the basis of the transaction results in legal consequences. Excuse from performance will be granted only where it is, in general, unreasonable to expect the obligor to fulfill the contract without any fault on his part.[145]

The principle recognized in the case of *Machine Games*,[146] where the court held that "the destruction of the basis of the transaction only has legal consequences where called for given the totality of circumstances and where necessary to avoid results which are intolerable and in general incompatible with law and justice."[147]

Although the principle of *force majeure* under German law is not established directly in the German Civil Code, the German courts have developed the doctrine and provided three provisions upon which cases of *force majeure* will be examined: the event was extraordinary and could not be foreseen; the event could not be prevented by using the greatest care possible; and the event could not remedied.[148] The German courts' approach is to deny claims for excuse from performance but to be willing to grant temporary remedies such as delay in performance. In one decision, regarding the invasion of Russian troops during World War I, the Supreme Court excused a seller from immediately taking up his business and performing his obligations after the invasion.[149]

The basic approach of German law, once exemption is granted on the basis of impossibility to perform, is to modify the contract to maintain the contractual relationship and to achieve an equitable and just settlement.[150] However, the modification of the contract and the share of losses should ensure that it provides a reasonable solution for the interest of both parties regarding their economic circumstances, the risk allocation under the contract, and the parties' originally expected profits.[151] If the adjustment in the contract is not justified, the contract will be terminated and the parties will be released from their obligations under the doctrine of good faith.[152]

The German law also allows a *pro rata* performance in cases where the basis of the transaction is destroyed and the nonperforming party is obligated on the same subject of the contract to some other creditors.[153] Under article 242 of the German Civil Code the nonperforming party is exempted from claims for damages.[154]

(c) Chinese Law

(i) The Chinese Legal and Economic System and Project Finance

After Deng Xiaoping came to power in 1978, a profound turn was made in the legal system of the Republic of China. The basic change was a turn from a longstanding policy of a closed centralized market, which was mostly off limits to foreign investors, to a more decentralized, market-oriented, incentive-based economy that was open to international trade.[155] The turn to an open-market economy led to an explosion of international economic contracts, which by the year 1990 exceeded US$700 million per year.[156] The change in economic policy and practice raised the need for further standardization of contractual language, which resulted in enactment of the law on Economic Contracts Involving Foreign Interest (FECL) in 1985.[157] To provide a more coherent law that will be applicable to all contracting areas, the Republic enacted the New Contract Law (NCL) of the People's Republic of China[158] in 1999, which is the applicable law today.[159] The legislation of the NCL was also a result of the Chinese Republic's goal to become a member of the WTO, while enacting contract law that is consistent with the standards of the international community.[160]

(ii) *Force Majeure*

According to article 117 of the NCL, a party that is unable to perform owing to *force majeure* can be exempted from damages, in whole or part, depending on the amount of performance that the party was able to accomplish prior to the *force majeure* event.[161] The article will not allow a party to be exempted from damage liability if the nonperforming party had already breached the contract prior to the occurrence of *force majeure*.[162]

In the former law of the FECL, to prove inability to perform due to a *force majeure* event, the nonperforming party had to provide a certification from the proper Chinese authority of the occurrence of such event.[163] That requirement was eliminated from the NCL, but the inclusion of the term "evidence" may still constitute such certification.[164]

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Article 121 provides a provision for breach of contract by a third party that is unable to perform due to *force majeure*, and states that "The party who breaches a contract because of a third party shall be liable to the other party for breaching the contract."

According to Article 121, an impediment stopping a third party from performing will not allow the affected contract party to claim a *force majeure* defense if the event does not directly affect the ability of the party itself to perform.[165]

Article 115 of the NCL provides the damage provision that would concern a party involved in an impediment dispute. It gives a party the right to have its deposit, paid as a guaranty, returned or used to offset payment if performance is completed.[166] However, if the party paying the deposit performs and the other party does not, the nonperforming party shall return twice the amount of the deposit to the original payer.[167]

Article 118 of the NCL requires the nonperforming party to give notice of its inability to perform. The article requires the nonperforming party to give the other party notice within a reasonable time to mitigate damages. However, it is important to note that this reasonable time standard is a question of interpretation and, therefore, could vary in its application to international parties operating in China.[168]

The revolution in the People's Republic of China, both political and economic, had a great influence on the international economic market, and some have argued that it will have much more influence on the world economy in the future. However, Chinese contract law, enacted at a time when China was pursuing its goal to become closer to the international community, provided that the *force majeure* standard under the NCL has a great similarity to the *force majeure* provision under harmonization codifications (CISG or the Unidroit, both discussed next). That notion of similarity can lead the Chinese government to accept a demand of the foreign party for the contract to be governed under such codification contract law. At the same time, that similarity can soften a restraint of the international party from governing the contract under Chinese law.

2.6 Harmonization Codifications of Contract Law

(a) Globalization and harmonization between different legal systems

"Globalization is a complex set of processes, not a single one, that are political, cultural, technological as well as economic, which made the world closer simultaneously and that has no connection to the term boundaries."[169]

In recent decades, we notice the development of a process of globalization that has an effect on every aspect of our life in connection with culture, politics, economics, etc., which has led to a process of harmonization in the broad fields of law.[170]

The idea of harmonization among legal systems is not new, as it happened long before in history while empires enforced their laws on the conquered countries, as happened with the Roman law that created the *ius commune*.[171] However, World War II and the development of commercial relations among countries through international or regional agreements, such as the GATT agreement and the creation of the WTO or the NAFTA agreement, and the creation of the EU, along with the breakthroughs in technology and transportation and the fall of the Communist regime, created the phenomenon of globalization, and now the world is often called a global village. That process has inherently aroused a need for harmonization among legal systems and especially in the area of international commercial transactions.

Although there is no unanimous view about the precise definition of the process of harmonization, it is commonly agreed that the term refers to unification and limiting gaps between different legal systems.[172] Under this process we will examine *force majeure* clauses in international commercial contracts, according to three major processes of harmonization: 1) the UN Convention on Contracts for the International Sale of Goods (CISG); 2) the Unidroit principles of International Commercial Transactions; and 3) the EU principles of Contract law.

(b) UN Convention on contracts for the international sale of goods

(i) The CISG and its Application on Project Finance Transactions

The UN Convention on Contracts for the International Sale of Goods (CISG) is a multilateral treaty proposed by the United Nations in 1980. As of April 2005, 63 nations (the contracting states) have ratified it.[173] The CISG's purpose is to promote international trade and to fulfill a quest for uniformity of international contract law.[174]

According to Article 1 of the CISG, there can be two cases for the CISG to apply: 1) the transaction is made between parties from different contracting states, and; 2) the rules of private international law (choice of law) lead

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to the application of the law of a contracting state.[175] The subject of the international contract must be the sale of commercial goods and must not cover sale of goods bought for household use,[176] a definition that inherently includes project finance transactions.

However, according to Article 6, the parties to the international transaction can decide whether to apply the CISG as the governing law of the transaction as part of their freedom of contract. (If the parties do not want the CISG to apply, they need to indicate that specifically. Otherwise the CISG will apply as a default rule.)[177]

(ii) *Force Majeure*

The CISG follows the civil law tradition of *force majeure* and provides under article 79 that *either* party may be excused from *all aspects* of the contract.[178] However, the CISG provision does not follow the civil law requirement of fault.[179] The scope of the CISG refers only to the doctrine of fundamental impossibility or frustration of purpose and does not include the UCC doctrine of commercial impracticability or the Unidroit doctrine of hardship where performance has become more difficult than originally anticipated.[180]

That distinction found its place also under the case law regarding article 79 for the CISG. In *Nuova Fucinati S.P.A. v. Fondmetall International A.B.*,[181] where the seller argued for excuse upon the fact that the price on the international market of the product to be delivered rose remarkably and unforeseeably and caused excessive burden (impracticability), the tribunal held that "the excessive burden doctrine does not fit within the structure of the Convention."[182]

Article 79(1) provides that a party claiming the right to be excused from performance needs to prove a three-prong test: (a) the failure was "due to an impediment beyond his control;"(b) at the time of the contract, the party "could not reasonably be expected to have taken the impediment into account;" and (c) subsequent to the contract, the party could not reasonably be expected to have "avoided or overcome the obstacle or its consequences."[183]

From a practical point of view, since a *force majeure* clause in a CISG contract may limit or supersede the applicability of Article 79, parties could negotiate *force majeure* excuses without regard to foreseeability.[184] Thus, even if a party could not claim excuse under Article 79, it could be excused by an event delineated in the *force majeure* clause.[185]

Article 79(2) deals with a third party's inability to perform. According to the article, the party needs to prove that it could not perform owing to the impediment and that the third party would be exempt under the *force majeure* defense.[186]

According to Article 79(3), once a *force majeure* event has taken place, the nonperforming party is excused only from its liability for failure to perform. The contract continues to exist unless and until it is avoided.[187] Once invoked, excuse remains in effect throughout "the period during which the impediment exists."[188] Thus, if the event is temporary, Article 79 does not allow a permanent excuse. As argued by Bund: "If the other party has not avoided the contract, the nonperforming party's obligation to perform may be reinstated once the impediment disappears."[189]

To excuse, Article 79(4) requires the party affected by the *force majeure* event to give the other party a notice of such occurrence, and to ensure that such notice was received. Otherwise, the party affected by the event is liable for damages resulting from the nonreceipt.[190]

Article 79(5) does not take any rights from the performing party other then the right to claim damages. Thus, as a stipulation of Article 81(2) of the CISG, a party who performed, or partly performed, without receiving the agreed return is entitled to redress that carries with it the right to restitution for expenses it prepaid or supplied under the contract.[191] Hence, the provided doctrine does not automatically discharge the contract and both parties from their contractual obligations, but only releases the nonperforming party from its liability for damages.[192]

From a theoretical point of view, the merit of the CISG compared to other forms of harmonization is in the fact that the CISG is binding and was ratified by the contracting states, which are the contractual parties themselves in project finance transactions (the countries where the projects take place). Thus, along with the fact that the CISG is translated also into six official versions,[193] it can be regarded as a neutral substantial law that governs contracts.[194]

However, from a practical point of view, there are triggers that weaken the CISG from providing a useful form of harmonization for the use of international commercial transactions.[195] First, many contracting states have adopted CISG subject to authorized declarations or interpretative comments.[196] Second, the freedom of contractual parties to waive the application of CISG from governing their contract has become a common practice. For example, as a general rule, U.S. lawyers take advantage of the opportunity to contract out of the CISG and they advise clients to negotiate U.S. choice-of-law pro-

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visions in their contracts.[197] Thus, while keeping in mind the advantages of the CISG, it is necessary to refer to other forms of harmonization as a substitute for the CISG or as a means for filling gaps left by the CISG.

The CISG doctrine of *force majeure* differs from other doctrines for nonperformance in two important issues. First, the CISG does not provide a soft doctrine for fundamental change in circumstances as provided by other legal systems: the doctrine of commercial impracticability (American law), the doctrine of frustration (Unidroit, and the European Principles), and the doctrine of *Imprévision* (French law). Second, the CISG provides that, as a remedy, the nonperforming party is only excused from its liability for damages, unlike the Draconian consequences of the common law doctrine that renders the termination of the contract. Hence, the CISG is more beneficial in long-term agreements and conforms to the community fairness approach for contract law.[198]

(c) The unidroit principles of international commercial contracts

(i) The Unidroit Principles and its Goals

Unidroit is an intergovernmental institute situated in Rome that acts to encourage the unification and harmonization between legal systems in private law.[199] The institute's intention was to prepare principles that will be acceptable to the majority of legal systems in the area of commercial contracts in international law.[200] The Unidroit Principles are not a binding instrument, but rather their application is contingent upon the will of the parties.[201] The objectives of the Unidroit Principles are to function as: 1) a model for internal legislation; 2) an interpretative tool for international conventions; 3) a guide to the drafting of international contracts; and 4) an instrument of *Lex Marcatoria* (quasi-common law in matters of international trade).[202]

In the context of project finance, which inherently involves an international commercial contract, the Unidroit can be a very useful tool for dispute resolution or for drafting the agreements themselves, while it is also regarded as a neutral code that attempts to strike a balance and compromise among different legal systems. For example, in an *Ad hoc Arbitration Tribunal* regarding a dispute involving a U.S. oil company that entered into a long-term contract with the government of a state formerly belonging to the Soviet Union to supply electric power, it was held, after the government enacted a fundamental change in the energy supply law, that the ambiguity regarding the new law should be filled by Article 6.2.3 of the Unidroit.[203] Furthermore, the fact that the Unidroit Institute has issued translations of the principles in French, Italian, German, Spanish, Russian, Japanese, Arabic, Portuguese, Dutch, Chinese, and Hebrew, emphasizes its merits in the project finance context.[204]

(ii) *Force Majeure*

The *force majeure* provision under the Unidroit is defined by Article 7.1.7(1) as a situation that "excludes a party's liability for its nonperformance due to an impediment beyond that party's control and that it could not reasonably be expected to have avoided or overcome it or its consequences."[205] The provision is Draconian, as described by Perillo, as "nothing short of total impossibility will excuse nonperformance or partial nonperformance."[206]

The effect of the clause is to excuse the nonperforming party from liability in damages, rather than to restrict the rights of the party who has not received performance to terminate if the nonperformance is fundamental.[207]

The provision has been taken almost literally from Article 79(1) of the CISG. However, the merit of the Unidroit principles over the CISG is that its application is upon the will of the contractual parties.

(iii) Hardship

The line between *force majeure* and hardship, and between fundamental and nonfundamental changes of circumstances is not always readily apparent.[208] Thus, according to Bonell, the *force majeure* article must be read together with the article dealing with hardship.[209] However, it is important to note that the article deals with *force majeure* under the nonperformance chapter, while the hardship article is presented under the performance chapter.[210]

Hardship is defined in Article 6.2.2 of the Unidroit Principles as a situation where the occurrence of events "fundamentally alters the equilibrium of the contract either because of the cost of a party's performance has increased or the value of performance a party receives has diminished."[211]

The rule of hardship is intended to provide a solution in situations in which overpricing or devaluation of the object of the contract disrupts the economic balance that the parties took into account at the time they were drafting the contract.[212] The provision of hardship will be applicable only where fundamental change has occurred. Whether an alteration is fundamental in a given case will

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depend upon the circumstances case by case.[213]

The requirements for hardship to arise are three: 1) the events occur or become known after conclusion of the contract; 2) the events could not reasonably have been taken into account by the disadvantaged party; and 3) the events were beyond the control of the disadvantaged party.[214]

The effects of hardship as defined by Article 6.2.3 offer to the disadvantaged party the possibility of resorting to a court or arbitration tribunal to have the contract adapted. The disadvantaged party must request to renegotiate without undue delay and the request must indicate the grounds on which it is based,[215] but the request for renegotiating does not in itself entitle the disadvantaged party to withhold performance.[216] Upon failure to reach an agreement within a reasonable time, either party may resort to a court or arbitral tribunal for a resolution.[217] The tribunal has the authority to terminate the contract or adapt it with a view to restore its equilibrium.[218]

From a practical point of view concerning the application of the excuse standard, it is important to note that since both hardship and *force majeure* can be raised upon the same factual basis, it is for the parties affected by these events to decide which remedy to pursue and directly to deem the contract to be excused or re-negotiated.[219]

The Unidroit Principles provide us with a modern harmonized form of codification of contract law whose inherent structure can stand upon its merits. The fact that the Unidroit is an intergovernmental institute, along with the fact that the Unidroit has been translated into numerous languages and has influenced the legislation of contract law in several countries, means that the Unidroit is a very neutral and legitimate tool to govern commercial contracts in international transactions. Furthermore, the voluntary applications of the Unidroit along with its goal to provide a stopgap system and interpretation tool further reinforces its merits. The fact that the CISG does not directly include a provision for exemption in the case of hardship suggests that the Unidroit hardship provisions serve as a stopgap role for the CISG doctrine of excuse.[220] In sum, the Unidroit Principles can be used to: 1) interpret the CISG, 2) answer unresolved questions that fall within the scope of the CISG, or 3) resolve issues that are not addressed in the CISG.[221]

(d) The principles of European contract law

(i) The Background to the Principles and its Application

The process of harmonization is more advanced in the European Union than in other parts of the world. The legislation of the European Community and the case law of its Court of Justice led to the birth of new law, representing the mixture of various legal systems.[222]

The Principles of European Contract law (EU Principles)[223] is the product of work carried out by the Commission on European Contract Law, a body of lawyers drawn from all of the member states of the European Union.

The main purpose of the EU Principles is to serve as a European civil code. However, until enacted, they will serve as a nonbinding way to unify European law, in a manner similar to the American Restatements.[224] In addition, the EU Principles are intended to operate as a model for judicial and legislative development of contract law, as well as a basis for harmonization of the member states' contract laws.[225]

According to Article 1:101(2) of the EU Principles, the principles will apply "when the parties have agreed to incorporate them into their contract or [provide] that their contract is to be governed by them."[226] Thus, the status of the EU Principles is not a binding convention as is the status of an international convention such as the CISG.[227]

(ii) Excuse Due to an Impediment

Article 8:108(1) of the EU principles provides that excuse from performance could be established where: (a) the event was outside the debtor's sphere of control; (b) it could not have been taken into account; and (c) it was of an insurmountable nature.[228]

Every impediment that fulfills the conditions set by PECL Article 8:108(1) relieves the nonperforming party from any liability, in contrast with CISG Article 79, which only provides the nonperforming party with a defense against an action for damages.[229]

Article 8:108(3) provides that it is the nonperforming party's duty to ensure that notice of the impediment and of its effect on that party's ability to perform is received by the other party within a reasonable time after the nonperforming party knew or ought to have known of these circumstances. If notice is not received by the creditor of the obligation, the nonperforming party will be liable for damages resulting from such nonreceipt.[230]

(iii) Hardship

Article 6:111(2) provides the exception for unexpected change of circumstances. The article provides that to be excused from performing, a nonperforming party needs to prove that (a) "the change of the circumstances

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occurred after the time of conclusion of the contract,"[231] (b) "the possibility of a change of circumstances was not one that could reasonably have been taken into account at the time of conclusion of the contract,"[232] and (c) "the risk of the change of circumstances is not one that, according to the contract, the party affected should be required to bear."[233] A party cannot benefit from such excuse where it has expressly agreed to undertake the risk of a specific change.[234]

According to Article 6:111(2) "if performance of the contract becomes excessively onerous because of change of circumstances, the parties are bound to enter into negotiations with a view to adapting the contract or ending it."[235] According to Lando, unlike the risk which results from total impossibility, the risks of unforeseen events that have brought a major imbalance in the contract will be shared between the parties.[236]

According to Article 6:111(3) the court has the discretion to intervene with the renegotiation if the parties fail to reach an agreement within a reasonable period of time. The court has discretion either "(a) to end the contract at a date and on terms to be determined by the court, or (b) to adapt the contract to distribute between the parties in a just and equitable manner the losses and gains resulting from the change of circumstances."[237] The court also has the discretion to award damages for the loss suffered through a party refusing to negotiate or breaking off negotiations contrary to good faith and fair dealing."[238]

2.7 Theoretical Approaches to Contract Law and *Force Majeure*

As in other issues, the issue of exemption from performance in cases of impossibility causes friction between two theoretical approaches to contract law: the law and economic approach, and the moral and fairness approach. While the economic approach regards the contract as a tool for risk allocation and efficiency, the moral and fairness approach regards the contract as a tool for mutual efforts and sharing of profits and losses.

(a) Law and economic approach

Under the law and economic theory advocated by Richard Posner and Andrew Rosenfeld, the risk of loss resulting from an unforeseen frustrating event should be allocated to the "superior risk bearer."[239] If the promisee is the superior risk bearer, the contractual obligation of the promisor is discharged.[240] If the promisor is allocated the risk of the unforeseen event and the loss thereof as the superior risk bearer, then the promisor must perform.[241] According to that standard, the party who could compete with a given risk more effectively than the other should bear the risk.[242] Determining which party is the superior risk bearer requires an assessment of which party was in a better position to prevent the risk from materializing—or in a better position to insure against the risk, which requires a determination of risk appraisal costs and transaction costs.[243] Hence, the court should assess which party had more information about the probability of the risk to occur and on the damage that would result in the events of such risk.[244]

For example, in *Transatlantic Financing Corp. v. United States*, it was held that the shipper is the superior risk bearer according to the information it holds and its accessibility to purchase such insurance, as stated by the court: "It is more reasonable to expect owner-operators of vessels to *insure against the hazards of war.* They are in the best position to calculate the cost of performance by alternative routes"[245] (emphasis added—K.M.).

However, the economic standard of the superior risk bearer has some disadvantages. First, contractual parties do not always foresee the risks to be allocated, so the assessment of who could effectively bear the risks may be unjustified.[246] In addition, even if the parties could foresee such risks, they often do not negotiate which party will bear them to limit the transaction costs that would have resulted, especially when they assess that the probability of their occurrence is low.[247] In *Transatlantic Case*,[248] again, where the closure of the Suez Canal resulted with delay of ship transportation, the court held that "foreseeability or even recognition of a risk does not necessarily prove its allocation.... Parties to a contract are not always able to provide for all possibilities of which they are aware, sometimes because they cannot agree, often because they are too busy."[249]

Another disadvantage is that the answer to the question of which of the parties can bear the risk most effectively is largely arbitrary and based upon speculation.[250] Such an approach is advocated also by Corbin, who argued that "where neither custom nor agreement determines the allocation of risk, the court must exercise its equity powers and pray for the wisdom of Solomon."[251]

(b) Community fairness of risk-sharing approach

Contrary to the efficiency approach, which advocates an economic theory that provides an efficient rule for exemption depending on the superior risk bearer, the advocates of the community fairness approach argue that

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the guiding principle for unforeseeable and unpreventable events, such as *force majeure*, should be sharing.[252] Support for such an approach could be found also in the Restatement (Second) of Contracts § 89 (1979), which requires modifications of executory contracts to be fair and equitable in allocating and sharing additional burdens.[253] Furthermore, according to Fried, the very fact that the parties themselves are freely creating contractual relationships imposes on them a duty of caring for each other.[254]

2.8 Final Conclusion for the Comparative Analysis

This comparative analysis reveals that there are more similarities than differences among the various legal systems regarding the approach to excuse from performance. The basic common provisions for recognizing excuse are: unforseeability, unavoidability, and externality (defined in different, but similar standards). However, the systems differ in the level of impossibility required and in remedies granted upon excuse from performance.

While history provides us with two main legal systems, common law and civil law, a harmonization and unification process has basically provided us with similar provisions and consequences regarding the same issues. Thus, we can refer to two major processes that will have profound influence on the future regarding exemption rules.

First, the process toward harmonization and unification of contract law in the field of international commercial transactions is part of the main process toward globalization. The process toward harmonization in that field has found its application in treaties such as the CISG and other forms such as the Unidroit Principles and the EU Principles. The fact that those three codifications provide, relatively, the same doctrine makes the actual doctrine appear to be more common, attractive, and legitimate. In addition, the fact that the EU, inherently, represents a compromise among different legal systems softens the friction on the way to achieving an agreeable exemption rule. Furthermore, the fact that the EU turns out to be a strong economic player in the world economy, as reflected by its currency, means that its rule will also take precedence over other rules for business conducted in the international field. However, for those who will argue and predict that in the following decades to come China will take the role of the leading player in the world economy, the answer is that, as shown earlier, the Chinese exemption rule is closest to and influenced by the CISG doctrine—a fact that turns us again to the same rule provided by the harmonization codifications.

Second, there is a movement toward a standard of risk allocation rather than standard of foreseeability. The influence of that process upon international transactions will find its application in purchasing insurance as an instrument of risk allocation and enhance the practice of drafting detailed *force majeure* clauses within contracts themselves.

3. PRACTICAL DISCUSSION OF RISK ALLOCATION

The contractual parties are eligible to waive or to extend any exemption from nonperformance granted by law as part of their freedom of contract, and as a matter of practice such parties often do so.[255] The application of such practice involves drafting of *force majeure* clauses, either by specific clauses allocating the risk of the events or by other mechanisms whereby the burden can be equitably shared.[256]

The reasons for such practice have emerged from the rejection of legal systems to recognize such excuses and the parties' intent to provide certainty to their contractual relationships. The need for such practice is more significant in long-term and international transactions such as project finance transactions. The duration of the contractual relationship makes it difficult for parties to anticipate future events in detail. The international nature of the deal provides a need to fill a gap between parties from different cultures, legal systems, and traditions.[257]

3.1 Managing the Risk of *Force Majeure* and Change in Circumstances

In this section, I will discuss ways to mitigate the risk of *force majeure* under the contract from a practical point of view regarding negotiation of the deal, insurance, and other instruments of risk allocation.

In a project finance transaction, risks are allocated to the parties best able to manage them and basically incorporated in the project's contractual and financial arrangements.[258] In a nonrecourse transaction, the risks of the financier are enormous. Since the loan can be repaid only when the project is operational, if a major part of the project fails, the financiers are likely to lose a substantial amount of money.[259] Risks may be allocated or limited in scope (restricted to geological risk, operation or maintenance, or *force majeure*) or by amount (limited to a per-

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centage of project debt or capital costs).[260]

The mitigation of risk involves three steps: 1) identification and analysis of all risks that may bear upon the project, 2) allocation of the risks among the parties, and 3) creating mechanisms to manage the risk.[261] While allocating the risk among themselves, the project participants follow the assumption of the law and economic theory that advocates that the risks should be allocated to the party who is the most appropriate to bear it.[262] That appropriation considers the ability to control and manage the risk as well as a party's financial capacity to insure against it.[263] According to Zakrzewski it has been observed that "financiers attempt to allocate uncontrollable risks widely and to ensure that each party has an interest in fixing such risks... [thus, for example] commercial risks are sought to be allocated to the private sector and political risks to the state sector."[264]

There are many devices (mostly financial) to mitigate risks relating to project finance transactions. However, in the following paragraphs I will analyze and describe the financial and contractual devices to allocate risks related to *force majeure* events and changes in circumstances.

***Mechanisms to manage* force majeure:** Such risks are, by their nature, the most difficult to fully mitigate. However, to minimize such risks, a party should conduct due diligence as to the possibility of the relevant circumstances of such events, allocate the risk to the other party as far as possible, and require adequate insurance.[265] That takes the financier's interests into account.[266] Moreover, according to some views, it will be helpful to demand from the host government a clear and unambiguous guarantee or statement of support for the type of investment being made.[267]

Political risks: Such risks are under sharp scrutiny in developing countries that are subject to political instability.[268] Mechanisms to manage such risks include requiring host country agreements and assurances that projects will not be interfered with; obtaining legal opinions as to the applicable laws and the enforceability of contracts in the host country; requiring political risk insurance to be obtained; involving financiers from a number of different countries, national export credit agencies, and multilateral lending institutions such as development banks; and establishing accounts in stable countries for the receipt of sales proceeds from purchasers.[269]

Mechanisms to manage currency risks:[270] Widely used mechanisms include matching the currencies of the sales contracts with the currencies of supply contracts as far as possible,[271] denominating the loan in the most relevant foreign currency, and requiring the contracting parties to enter into suitable foreign currency hedging contracts.[272] Furthermore, the sponsor may be required by the lenders to enter into *hedging contracts*, which are financial devices used to reduce losses as a result of future price changes.[273]

Mechanisms to manage market risk: One mechanism is a tracking account compensation device. Tracking accounts are often used to compensate input suppliers or off-takers for offering fixed-price agreements, which shield project sponsors from market risk. Under an off-take agreement that provides for tracking, if the contract price exceeds spot market prices, the difference between the two would be tracked.[274]

3.2 Insurance and World Bank Guarantees

A simple, though expensive, way to mitigate and manage the risk of change of circumstances is to purchase an insurance policy. That solution is consistent with the law and economic theory that provide that such insurance should be purchased by the party that is in the best position to control unfavorable events and has the greatest financial capability to purchase such insurance.[275]

Political, legal, and currency exchange risks can be easily insured. However, purchasing an insurance policy against *force majeure* events is much more complicated and expensive, especially after the terrorist attacks of September 11.[276] Insurance for most of those risks can be obtained from multilateral development agencies such as the World Bank and its Multilateral Investment Guarantee Agency. Political risk coverage can also obtained on the private market, for example, from Lloyds of London.[277]

World Bank guarantees are partial in that they cover the minimum number of risks and the smallest amount of debt consistent with successful implementation of a project.[278] If project debt service is interrupted by failure of the government to make payments as required, guarantee lenders may reimburse payments from the World Bank, which will then demand reimbursement from the government under the terms of an indemnity agreement.[279] For example, in August 1997, the IDA provided a Partial Risk Guarantee for the $180 million Haripur Power Project in Bangladesh to cover currency convertibility or transferability, changes in laws, political *force majeure*, natural *force majeure*, and frustration of arbitration.[280]

However, insurance for *force majeure* events remains a major problem. According to Rigby, the terrorist attacks on September 11 had a harmful influence on the availability

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of insurance to project sponsors, and the resulting lack of such insurance can potentially erode project credit.[281]

3.3 Practical Advice to Drafters of *Force Majeure* Clauses

"When a force majeure provision is included in 'take-or-pay' contract, the contract's enforceability usually depends on the language of the provision and how it is triggered."[282]

As a direct result of the dissimilarity of the doctrines of impossibility to perform, it is most important, first, to define the meaning of the event and legal concept that will trigger the *force majeure* clause.[283] By drafting a *force majeure* clause, parties can delineate the types of "extraordinary circumstances" that will excuse performance, and thereby increase predictability and overcome the obstacle of foreseeability in most legal doctrines.[284] The clauses should be as specific as possible. According to Bund "courts may be more willing to give effect to 'laundry list' *force majeure* clauses that contain specific events, rather than to a catchall... clause."[285] Furthermore, the clause should note that "the catchall provision covers 'any other event, whether similar to the causes specified above.'"[286] In that connection, it is also suggested that the parties will waive the rule of *contra proferntem*, which literally means "against the party putting forward," to avoid interpretation of the clause in a case of ambiguity, against the party that drafted the clause.[287]

The clause should explicitly state whether a *force majeure* event excuses performance permanently or only temporarily, and to what extent of impossibility is an excuse for nonperformance (absolute impossibility or change in circumstances).[288] It is also helpful to categorize the risks according to the phase of the project within which they may arise.[289] Thus, the scope and the extent of the defense or even the allocation of the risk itself can change between the different phases.

Other issues that should be of concern in *force majeure* clauses, according to guidelines of the World Bank, are the authority to be responsible for identifying and assessing the damage; procedure for assessment of additional investment requirements, demand projections, and cost recovery calculations; measures required to bring the system back into operation and minimize the recovery period; and procedures for notification and suspension.[290] Furthermore, if the failure to perform is due to a governmental intervention, then the agreement should address this intervention in the section dedicated to materially adverse governmental action, which should be separate from the *force majeure* clauses.[291] To preserve the coherence of risk allocation, different project documents should have "back-to-back" uniform *force majeure* clauses.[292]

4. FINAL CONCLUSIONS

"Although hardship, force majeure and special risks clauses are by now a common element of international contract practice, many difficulties still arise... Some may be avoided by careful negotiation; others, will always arise from the inevitable uncertainty and speculation attending contracts dependent on future developments."[293]

Project finance transactions are special. They combine an endless spectrum of business and legal challenges and concerns. Moreover, it can be argued that while its main purpose, for the investors of the projects, is a direct economic benefit, a project finance transaction fulfills a major role in the world economy and process of globalization. Hence, it is not surprising that the World Bank and similar multilateral agencies are willing to guarantee and insure against risks of such transactions. However, the success of such projects depends greatly upon the way the parties to the transaction allocate and manage the enormous risks related to the transaction. In that risk-allocation process, careful thought should be given to the law that will govern the agreement and the doctrines that stem from that law. In this article, I have assessed one risk related to a project finance transaction—the risk of *force majeure* and fundamental change in the circumstances—from a comparative and practical point of view. While the risk of *force majeure*, by its nature cannot be fully allocated, it is important for the project finance practitioner to be familiar with the various doctrines applicable to such risk and the ways to minimize it upon negotiating and drafting the project agreement.

Editor's Note

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the risk of such completion, sponsors are often required to furnish some sort of guarantee, which commits the sponsors to input additional capital to the project in the event of cost overrun or to pay all or part of the project debt upon failure to attain completion. However, the hallmark of the adoption of project financing arrangements by the sponsors is the limitation of recourse and the sharing of risk. Such completion guarantees could turn non-recourse or limited-recourse into full-recourse financing from the sponsors' perspective. This article explores the prospects of options available to project sponsors to mitigate their obligations under completion guarantees in the context of oil project financing. In advancing this analysis, the article examines the nature of oil projects in relation to project financing, looks at the relevance of completion in the repayment of the project debt, and reviews lenders' aversion to assuming completion risk and their requirements from project sponsors in mitigation.

PROJECT FINANCE AND THE PRIVATE FINANCE INITIATIVE (PFI) **67**

RIFAT AKBIYIKLI, DAVID EATON, AND ANDREW TURNER

Private Finance is one method of financing large-scale, capital intensive projects, in which traditionally only the cash flows generated by the project serve as the source of loan repayment and only the project assets serve as collateral for a non-recourse loan. An important aspect of this form of project finance is that the risks are borne not only by the sponsors but are shared by different types of investors such as equity holders, debt providers, and quasi-equity investors. Therefore, because the risks are shared, the criterion of a project's suitability for financing is whether it is able to stand alone as a distinct legal and economic entity with project assets, project related contracts, and project cash flows separated from those of the sponsors. This form of project financing, since it relies on the security of cash flows, requires a detailed awareness, identification, assessment, and quantification of all the risks. Consequently, a comprehensive and heuristic risk management process is essential for the success of the project. The lenders and other providers of equity and debt play important roles in the implementation of the risk management plan and hence affect the likely overall project success. The structure of this financing and investment on a particular project enables all project stakeholders to take a long-term perspective on the project, thus permitting the various contractors and investors in the project to work together with a common financial interest in creating a whole-of-life, cost-effective project that achieves full client satisfaction and performance to requirements. This article is limited to an examination of the project finance issues in PFI Road Projects in the UK. It presents the conclusions from the detailed analysis of three major UK PFI Road Projects.

FORCE MAJEURE* IN PROJECT FINANCE: *A Comparative and Practical Analysis of Risk Allocation **76**

KFIR MIZRACHI

For project finance transactions, which take place largely in developing countries that are subject to unstable environments, special attention is required in the drafting of project agreements. In that connection, *force majeure* events (known also as frustration, impossibility, impracticability, Imprévision and Wegfall der Geschaftsgrundlage) pose a major risk to the success of projects. The fact that the parties to the transaction are generally from different countries, with different legal systems and contract law, requires the drafters of project agreements to be particularly careful, since a contract's enforceability will depend on the language of the provision and how it is triggered according to the law that governs the contract. The article examines how different systems of law (common law, civil law, CISG, Unidroit, and the EU law) and different theoretical approaches to contract law deal with force majeure events and provides practical advice for drafters of project agreements to allocate and minimize that risk.

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SAMANTHA ROWAN

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