Regulating International Contracts in a Pandemic: Application of the *Lex Mercatoria* and Transnational Commercial Law

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Abstract

The Covid-19 pandemic is a significant disruption for the performance of contractual obligations. Contracts often contain a force majeure clause that lays out the circumstances under which a contract can be terminated or suspended. However, not all contracts contain such a clause, or the clause might not cover the current situation. In the absence of a force majeure or similar type clause the applicable law fills that gap.

This paper concentrates on international commercial law contracts and transnational commercial law; it specifically focuses on the Convention for the International Sale of Goods,[1] the UNIDROIT Principles of International Commercial Contracts,[2] and the principles of the *lex mercatoria*. This paper analyses how these instruments could be applied if the contractual parties do not meet their obligations because of the Covid-19 pandemic.

I. Transnational Commercial Contracts in Times of Corona

a) Introduction

The Covid-19 pandemic significantly disrupts the performance of a large number of contracts. This can be because the performance of the contract is now impossible, illegal, no longer necessary, onerous, or simply inconvenient for the contracting parties. The key question is how the law deals with non-performance caused by the pandemic. In most cases hopefully the parties will come to an amicable agreement about the termination or modification of the contract. In other cases, however, that might not be possible; one of the parties may not wish to terminate/modify or the parties cannot reach agreement on how consequences of any changes should be attributed.

This paper analyses contractual disruption due to Covid-19 focussing on international commercial law contracts and transnational commercial regulations. This entails contracts where both parties operate in a commercial capacity and concerns sales, services, hire-purchase, and agency agreements among others. International commercial law contracts regularly include non-state rules such as transnational commercial law instruments or the *lex mercatoria* in the choice of law clause, either as the applicable law or by reference as contractual rules. Even in the absence of any reference in the contract, arbitrators and courts apply non-state rules with some regularity.

The Convention for the International Sale of Goods (CISG) and the UNIDROIT Principles of International Commercial Contracts (UPICC) are two of the most prominent examples of transnational commercial instruments. This paper analyses how these instruments could be applied if the contractual parties do not meet their obligations because of the pandemic.

[1] United Nations Convention for the International Sale of Goods (adopted 11 April 1980, entered into force 1 January 1988).
[2] UNIDROIT Principles of International Commercial Contracts (2016 edition).

It furthermore examines how a court or tribunal would decide on issues related to the pandemic if the *lex mercatoria* is applied. The next section discusses the relationship between the force majeure clause and the applicable law. The following part introduces the CISG and the UPICC and discusses how these instruments approach force majeure. The final part examines how, when applying the *lex mercatoria*, the court/tribunal could deal with breach of contract resulting from Covid-19 and concludes with some reflections on the likely effect of Covid-19 in relation to contractual modification or termination under transnational commercial law.

b) Force Majeure and the Applicable Law

The court/tribunal firstly looks at the contractual provisions, given that the contract is said to be the first source of contract law.[3] Contracts often contain a force majeure and/or hardship clause (or similar) that will lay out the circumstances under which a contract can be cancelled, modified, or suspended. Such a clause typically includes a description of the type of situations that are covered by it, for instance war, strikes, acts of God, and eventually pandemics. However, not all contracts contain such a clause and even when they do, the clause might not cover pandemics (or it may be formulated in such a way that it is unclear whether it does). In the absence of a force majeure or similar type clause, the applicable law fills in the contractual gaps to resolve the dispute.

For instance, if English law is the applicable law, then the doctrine of frustration is applicable. The threshold for frustration is high; the contract needs to be either impossible to perform,[4] illegal,[5] or the main purpose of the contract must have been thwarted.[6] This could cover difficulties caused by a pandemic but would not cover all contracts that are disrupted because of the pandemic. For instance, it would not cover the situation where the contract can still be performed, although performance might now be significantly more onerous for one of the parties. Therefore, if the contract does not contain an adequate force majeure clause it could very well be that the contract cannot be terminated without one of the parties being in breach and thus liable to pay damages. Other jurisdictions have similar doctrines, such as force majeure in France and *Unmöglichkeit der Leistung* in Germany, although these each operate somewhat differently and will have a different threshold as to when a contract can be terminated without incurring liability.

The parties to an international commercial contract can insert a choice of law clause in their contract for the application of non-state rules. With non-state rules is meant the body of transnational commercial law that is either developed by international organisations and trade associations (such as restatements of laws and standard terms and conditions) or emerges spontaneously from usage by merchants (trade usages) and is refined through application by courts/tribunals (creating general principles of transnational commercial law). Non-state rules are thus created by other entities than the state and aim to facilitate international commerce through legal unification. Whilst a choice for non-state rules is not permitted in most jurisdictions in litigation, it is usually permitted for arbitration.[7] This choice could be formulated in a precise manner by referring to a transnational commercial law

[3] Jacques Ghestin, 'La notion de contrat' (1990) 12 Periodicals Archive Online 7, 10.
[4] *Taylor v Caldwell* [1863] EWHC QB J1.
[5] *Fibrosa Spolka Akcyjna v Fairbairn Lawson Combe Barbour Ltd* [1942] UKHL 4.
[6] *Krell v Henry* [1903] 2 KB 740.
[7] See for instance, UNCITRAL Model Law on International Commercial Arbitration (1985) Art. 28. Legislation based on this model law has been adopted by 83 states.

instrument by name (such as the UNIDROIT Principles) or could employ a formula such as general principles of commercial law, accepted transnational commercial practices, or the *lex mercatoria*. It is then up to the tribunal to find and decide the general principles and concrete rules of the *lex mercatoria*. There is no agreement on what the substance of the *lex mercatoria* is, as the intense debate on the subject shows.[8] Tribunals often refer to transnational commercial law instruments as an expression or reflection of the *lex mercatoria*;[9] that is to say as a source of the *lex mercatoria* or as the written evidence of the *lex mercatoria*. The instrument that is used most often for this purpose is the UNIDROIT Principles (others include the Principles of European Contract Law (PECL) and the Principles of Latin America Contract Law (PLACL) as well as the Incoterms[10]).

II. Transnational Commercial Law Instruments

a) The Convention for the International Sale of Goods

The CISG is also regularly used by courts/tribunals as a reflection of the *lex mercatoria*. It is debatable whether conventional law should be included in the *lex mercatoria* (or indeed whether codified non-state rules should be included at all) but regardless of whether it is desirable it is often applied in this way. Aside from being used as *lex mercatoria*, the CISG is a leading convention that is ratified by 93 states as of 2020.

The underlying principles of the CISG are characterised by internationality, good faith, uniformity in interpretation, pragmatism, and freedom of contract. The CISG has a strong *favor contractus* approach: preserving the contractual relationship is key. It offers limited possibilities to rely on force majeure. There is *no rebus sic stantibus* type provision which allows the contract to be modified or terminated if there is a significant change in circumstances.

Art. 79 discusses non-liability for performance:

> A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it, or its consequences.[11]

Non-liability is only valid for the duration of the event.[12] Whilst the party in breach will not be liable for any damages, the other party can still avoid the contract if the breach is considered fundamental: 'Nothing in this article prevents either party from exercising any right other than to claim damages under this Convention.'[13] The contract is only terminated when it is avoided and not retroactively upon occurrence of the impeding event.[14]

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[8] See for instance, Klaus Peter Berger, *The Creeping Codification of the Lex Mercatoria* (Kluwer Law International 1999); Gilles Cuniberti, 'Three Theories of Lex Mercatoria' (2013) 52 Columbia Journal of Transnational Commercial Law.
[9] See the UNILEX database for examples: http://www.unilex.info/instrument/principles.
[10] The International Commercial Terms created by the International Chamber of Commerce to facilitate the international sale of goods, available at: https://iccwbo.org/resources-for-business/incoterms-rules/incoterms-2020/.
[11] CISG Art. 79 (1).
[12] CISG Art. 79 (3).
[13] CISG Art .79 (5).
[14] Jacob Ziegler, 'Report to the Uniform Law Conference of Canada on Convention on Contracts for the International Sale of Goods', July 1981, available at http://cisgw3.law.pace.edu/cisg/text/ziegel79.html.

Understanding how impediments should be interpreted is key to understanding the scope of the article. The definition of impediment is not immediately clear from the article, which has been criticised for its generality and lack of detail.[15]

The CISG Advisory Council is a private initiative from a group of scholars and publishes opinions on the interpretation of the CISG. Whilst these opinions are not canon, they have persuasive value as they are based on caselaw and the legislative history of the CISG. Opinion 7 discusses the interpretation of Article 79 and includes an analysis of existing caselaw. It explains that overall, courts and tribunals take a strict interpretation of Article 79. Courts do not rely excessively on domestic law interpretations of hardship and force majeure which might have a broader approach, and they maintain high standards for exemption of liability.[16]

Clearly Covid-19 can lead to economic hardship. Would such a situation fall within the scope of Article 79? The legislative history clarifies that impediment should not only cover situations where it is physically impossible to perform the contract but also, under limited circumstances, those situations in which it is economically problematic to do so.[17] Overall, however, the courts have taken a reticent approach to accepting economic hardship as an excuse for non-performance.[18] It could be that Covid-19 represents such a sufficiently exceptional situation that courts would take a more flexible approach, however it could also be said that certainty in deciding contractual disputes is needed now more than ever and therefore the standards for exemption are likely to remain high.

If Article 79 is rather general, how should the courts, then interpret any request for relief? According to Article 7, any matters covered by the CISG but not explicitly discussed should be settled by relying upon the principles underlying the CISG, If such principles are not found, the courts should turn to the applicable law to settle the issue (and not the *lex fori* as some courts have the tendency to do).[19] Turning to the applicable law creates uncertainty for the parties and should therefore be the last resort. It is not recommended that the applicable law should be used to further define what an impediment is or whether hardship should be covered, given the diverse approaches taken by different jurisdictions. This would lead to unpredictable results for the parties because they cannot anticipate the outcome of the dispute that well. Rather, courts should rely upon the extensive CISG caselaw to interpret the Convention and extend the scope of impediment to include exceptional economic hardship. It would be especially appropriate to grant such relief if the equilibrium of the contract is destroyed and where one of the parties stands to profit whilst the other party suffers extensive losses because of the unforeseen event.[20]

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[15] Ibid. See also, Harry Flechtner, 'Article 79 of the United Nations Convention on Contracts for the International Sale of Goods (CISG) as Rorschach Test: The Homeward Trend and Exemption for Delivering Non-Conforming Goods' (2007) 19 Pace International Law Review 29.
[16] CISG Advisory Council Opinion No. 7: 'Exemption of Liability for Damages Under Article 79 of the CISG,' 2007, http://www.cisgac.com/cisgac-opinion-no7/.
[17] Peter Schlechtriem, 'Uniform Sales Law - The UN-Convention on Contracts for the International Sale of Goods', 1986, http://cisgw3.law.pace.edu/cisg/biblio/schlechtriem-79.html.
[18] CISG Advisory Council, Opinion No. 7: 'Exemption of Liability for Damages Under Article 79 of the CISG,' 2007, http://www.cisgac.com/cisgac-opinion-no7/.
[19] Franco Ferrari, 'Homeward Trend and Lex Forism in International Sales Law' (2009) International Business Law Journal 333.
[20] Joseph M. Perillo, 'Force Majeure and Hardship under the UNIDROIT Principles of International Commercial Contracts,' (1997) 5 Tulane Journal of International and Comparative Law 5-28, 14.

The approach of the CISG favours certainty in contractual relationships rather than allowing for flexibility should the situation change. At the same time the pragmatism that is reflected in the CISG through, for instance, the requirement to mitigate damages (Article 77) and allow for a period of grace/*nachfrist* (Article 49), suggests that the parties should maintain if possible, a certain flexibility towards each other if situations change. The CISG does not include an explicit duty to renegotiate in cases of hardship but there is caselaw suggesting that such a duty is implied in the principles underlying the CISG.[21] This suggests that exempting a party from liability in exceptional circumstances such as Covid-19 for reasons of economic hardship is permitted under the CISG.

b) The UNIDROIT Principles of International Commercial Contracts

The UNIDROIT Principles of International Commercial Contracts (first published in 1994) are a restatement of international commercial law. They are the result of a comparative study between the commercial laws of different states and the common practices between international merchants and they seek to provide the best possible legal solutions for facilitating international trade.[22] They can be applied if the parties choose them as the governing law, if the parties have chosen the *lex mercatoria* as the governing law, and to interpret the contract, the law, and international conventions (such as the CISG).[23]

Article 6.2 covers questions of hardship. Article 6.2.1 provides 'Where the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations subject to the following provisions on hardship.' The official commentary reinforces that even if the contract is now significantly more costly or no longer beneficial for one of the parties, they still need to perform, unless there are exceptional circumstances.[24] Whilst economic risks can undoubtedly cause a significant imbalance in the contract and provide difficulties, hardship should only be applied if the economic difficulties go significantly beyond normal market developments.[25] The consequences of Covid-19 would qualify as such a development, given that the scale of disruptiveness clearly goes beyond any expected economic disruption.

Article 6.2.2 provides that the principle is not 'absolute' and that it applies 'when supervening circumstances are such that they lead to a fundamental alteration of the equilibrium of the contract.' The event must be outside of the control of the disadvantaged party and the party must not have assumed the risk for such an event. This means that if the contract contains a clause where the party has assumed the risk for a pandemic occurring, they could not rely on the provisions of hardship. This could either be explicitly (if the contract refers to a pandemic/epidemy) or implicitly (if the party assumes all risks no matter outside events occurring for instance). To qualify, the event must have become known or occurred after the conclusion of the contract. Therefore, it is unlikely contracts concluded after March 2020 could rely upon this article to be exempted from liability.

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[21] Julie Dewez et al, 'The Duty to Renegotiate an International Sales Contract under CISG in Case of Hardship and the Use of the Unidroit Principles' (2011) 19(1) European Review of Private Law 101.
[22] Michael Joachim Bonell, 'Unidroit Principles of International Commercial Contracts: Why What How,' (1994-95) 69(5) Tulane Law Review 1121-1148, 1129.
[23] Preamble (Purpose of the Principles).
[24] UNIDROIT Principles of International Commercial Contracts 2016, 217.
[25] Dietrich Maskow, 'Hardship and Force Majeure', (1992) 40 The American Journal of Comparative Law 657-669, 662.

The effects of hardship (Article 6.2.3) are that the disadvantaged party is first entitled to request renegotiations, but such a request does not of itself entitle the party to withhold performance. If these negotiations are unsuccessful, they can turn to the court who, if it finds hardship may terminate the agreement or adapt the contract to reach an equilibrium between the parties which could according to the official comments on the article entail a price recalibration. Equilibrium should not be interpreted as contractual fairness but should be based on 'the intended effect of the contract on risk and reward,' and thus concerns the effect on the purpose of the contract.[26] For instance, if an electronics company cannot source specific goods because of a lockdown caused by Covid-19 they will have no need of transportation. The carriage contract that they have with a truck company can still be performed given the trucks can still ride between A and B. However, there is no purpose to the contract anymore for the electronics company if they have no goods that need to be transported.

Article 7.1.7 discusses force majeure. Force majeure is a container concept that means different things depending on the jurisdiction. The official comments on the Article discuss that the term was chosen because it is well-known in international trade and covers the same ground as the common law concept of frustration and the civil law concept of force majeure but it should not be seen as identical to these domestic law concepts.[27] The official comments on Article 7.1.7 state that a party's non-performance is excused if this was 'due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.'[28]

Article 7.17 furthermore states that if the impediment is only temporary than it has effect for that period and that 'nothing in this Article prevents a party from exercising a right to terminate the contract or to withhold performance or request interest on money due.' Therefore, like the CISG, it excuses liability for damages, but it does not waive other rights. Whilst under the CISG, impediment is interpreted to include economic hardship, this is not the case for the UPICC. As the UPICC has a separate article on hardship, impediment should be interpreted in a strict manner and refers to an event that makes the contract impossible to perform.[29] Whilst Covid-19 does make some contracts impossible to perform and this provision can therefore be relied upon by the disadvantaged party, for other contracts there will thus be a need to rely on the hardship provisions to escape liability rather than on the force majeure provisions.

The UPICC offer a more comprehensive approach to hardship and non-performance than the CISG. It even confers (controversially) the power on courts/tribunals to adapt the contract to restore the equilibrium (which the CISG does not do). At the same time the UPICC also emphasise the exceptionality of the event, again safeguarding the contractual obligations. The official comments stress that these articles would mainly be applied to long term contracts, therefore for shorter and single transactions the approach would be more stringent.[30]

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[26] Donald Robertson, 'Symposium Paper: Long-Term Relational Contracts and the UNIDROIT Principles of International Commercial Contracts,' (2008) Australian International Law Journal 185, 188.
[27] UNIDROIT Principles of International Commercial Contracts 2016, 240.
[28] Ibid, 241.
[29] Joseph M. Perillo, 'Force Majeure and Hardship under the UNIDROIT Principles of International Commercial Contracts,' (1997) 5 Tulane Journal of International and Comparative Law 5-28, 15.
[30] UNIDROIT Principles of International Commercial Contracts 2016, 242.

Good contractual relationships are at the centre of the UPICC. Parties should first negotiate if there is hardship. The UPICC emphasise the general principles of good faith and fair dealing (Article 1.7) and incorporate a specific duty of cooperation (Article 5.1.3). Parties should be flexible and cooperative towards one another, and whether they demonstrate this cooperation can play a part in the deliberations of the court/tribunal.

Both the CISG and the UPICC refer to the temporality of the event, which means performance could be merely suspended. Whilst one hopes that Covid-19 is a temporary event, the duration of it is likely to be long-term, certainly months and perhaps years. The courts should take into account that it is unforeseeable how long the pandemic will continue and therefore this might favour termination over suspension.

III. Principles of the *Lex Mercatoria*

a) Applying the Lex Mercatoria

If a tribunal/court is applying the *lex mercatoria* they might choose to use transnational instruments such as the UPICC or the CISG (or both). The court might also come to a reasoned conclusion of what the general principles of transnational commercial law and trade usages are that should be applied.

Trade usages are considered implied terms of the contract under Article 9 of the CISG and Articles 1.8 and 4.3 of the UPICC. They form the cornerstone of the *lex mercatoria*. Usages clarify how force majeure and hardship should be interpreted in different trades (which could mean a broader or stricter interpretation depending on the trade) and need to be applied by the court/tribunal, immediately after the express contractual provisions.

A key principle of the *lex mercatoria* is a strong *favor contracus*; that is to say the need to interpret the legal provisions in a way that as far as possible upholds the contract. Termination is a last option. This combined with the principle of *pacta sunt servanda* means that under the *lex mercatoria,* terminating a contract should only be done as the last resort. Legal uncertainty is one of the key detriments for trading abroad and therefore predictability and security are important for the contracting parties.[31] The barrier to non-liability for non-performance is thus high. This means that in principle even in times of Covid-19 the court should uphold the contract and the obligations of the parties as far as possible. Clearly this situation affects a myriad of contracts and certainty is thus even more important.

Good faith is a key principle of the *lex mercatoria* and the UPICC. Good faith is also one of the principles underlying the CISG although from the wording it seems that it is the Convention rather than the contract that needs to be interpreted in good faith. The wording of the good faith principle is vague because the CISG is trying to bridge common law and civil law.[32] English common law does not recognise an overall good faith obligation, differently from civil law. Good faith is recognised as a principle of the *lex mercatoria*, probably partly because the origins of the *lex mercatoria* are in Roman law and much of its development took place in Italy and France. Furthermore, the revival of the *lex*

[31] Clive M Schmitthoff, 'American and European Commercial Law' (1979) 6 Journal of Legislation 44, 44.
[32] For an analysis see for instance, Ulrich Magnus, 'The Vienna Sales Convention (CISG) between Civil And Common Law - Best of All Worlds,' (2010) 3(1) Journal of Civil Law Studies 67-98.

mercatoria started with the work of French scholars.[33] Good faith would imply that the parties deal with each other in a transparent and honest manner. The *lex mercatoria* emphasises equity and fairness.[34] This should especially be taken into account if unexpected outside events such as Covid-19 cause significant hardship for one of the parties.

The principle of *Clausula Rebus Sic Stantibus* allows the parties to modify or terminate an agreement because of serious disruptions and is considered part of the *lex mercatoria*. In combination with the good faith requirement it means that parties should be willing to renegotiate. If an event happens that would not have been in the contemplation of the parties (like Covid-19) then the fundamental changes to their obligations would not have been intended by the parties and this vitiates their consent.[35] Therefore, there is a strong case for saying that despite the key principle of contractual certainty, extreme economic hardship caused by Covid-19 is a cause for renegotiation.

b) Conclusion

The WHO declared Covid-19 a pandemic on 11 March 2020. The effects of the pandemic were already felt before that and certainly will continue to be felt for the foreseeable future. Both the CISG and the UPICC emphasise that for the terms of the contract to be vitiated, the event should not be foreseeable. The question of foreseeability is complicated, however. Can it be foreseen that a pandemic might occur at some point? Yes, of course, it has happened in the past and will happen again. Can it be foreseen in what manner it will occur or when? No, of course not. Caselaw shows that courts struggle with the notion of foreseeability, especially in long-term contracts, that might have decades of running time. Within that time all sorts of events including wars and natural disasters can be expected to happen, even if we do not know the precise shape they will take. A pandemic can be expected to occur at some point given that in human history we see a pattern of disease outbreaks, but how likely it is to happen, and would the parties have contemplated this at the time of contracting? There is a grey area with a margin of appreciation. The next years will undoubtedly bring contradictory caselaw on the foreseeability of Covid-19.

For any contract concluded after 11 March 2020 it would be difficult to rely upon the pandemic as an excuse for non-performance. It could even be argued that before 11 March, the outbreak was already so prominent that it was foreseeable that this would create hardship.[36] It is also clear that the exact consequences of the pandemic could not be foreseen on 11 March and there are still more questions than answers with regards to the immediate future. But clearly the pandemic itself is now a reality and relying on it as an excuse for non-performance will be more difficult. This is not to say that it can never be relied upon but the party in breach will face a higher threshold to prove that the effects were unforeseen. This makes the inclusion of a force majeure/hardship clause even more

[33] See for instance, Harold J Berman, 'The Law of International Commercial Transactions (Lex Mercatoria),' (1987) 2 Emory Journal of International Dispute Resolution 235. For the renewal of the lex mercatoria see, Klaus Peter Berger, 'Berthold Goldman and the Dijon School: The rebirth of the Lex Mercatoria' (undated), http://www.trans-lex.org/000001.

[34] William Mitchell, *An Essay on the Early History of the Law Merchant* (Cambridge University Press 1904) 13.

[35] Joseph M. Perillo, 'Force Majeure and Hardship under the UNIDROIT Principles of International Commercial Contracts,' (1997) 5 Tulane Journal of International and Comparative Law 5-28, 13.

[36] On 30 January 2020, the WHO already declared Covid-19 a public health emergency of international concern.

important. This force majeure clause should cover pandemics explicitly to maximise the security of the parties. [37]

In conclusion it can be said that under the rules discussed, the approach is to favour certainty first. Therefore, the threshold to excuse non-performance is high. Whilst Covid-19 is an exceptional situation and clearly could not have been expected by either party the importance of certainty for international commercial contracts is paramount and courts/tribunals will likely continue with a strict interpretation of these rules. At the same time, the principles of good faith and fair dealing combined with the pragmatism of international trade also call for the parties to be cooperative and flexible towards one another in order to come as far as possible to an amicable settlement.

[37] See for example, ICC Force Majeure and Hardship Clauses, available at https://iccwbo.org/publication/icc-force-majeure-and-hardship-clauses/.