

Your Contractual Question Answered

What is *Force Majeure* and can it include Price Escalation?

By The Entrusty Group

Entrusty Group, a multi-disciplinary group of companies, of which, one of their specialisation is in project, commercial and contractual management, has been running a regular contractual questions and answers section in the Master Builder Journal.

In this instalment of this series, **Entrusty Group** will provide the answer to another frequently asked question – **What is Force Majeure and can it include Price Escalation?**

Introduction

The construction industry is always known to be a complicated and fragmented industry, where external factors that are beyond the control of the parties involved or are independent of the construction works, can cause problems to the progress and/or cost of the work. Risk is one of these external factors that can pose significant threats and uncertainties to the construction project. Foreseeable risks can be tackled through the proper application of risk management. However, the same cannot be said for unforeseeable risks. Are *force majeure* clauses the answer to address this problem?

In this article, we aim to provide an understanding of *force majeure* and its application in tackling these unforeseeable risks. Although *force majeure* clauses are common in standard forms of construction contracts, they are frequently misunderstood by the Malaysian contractors due to the rarity of such events happening in Malaysia. However, this clause is pertinent, particularly for construction projects outside of Malaysia.



Definition of *Force Majeure*

Force majeure, pronounced “fors mahzher”, is defined as any events or circumstances that are beyond the control of man which either hinder or prevent the performance of work despite the exercise of due

care. Therefore “a *force majeure* clause is a contractual provision which may allow a contracting party to escape liability for non performance of its contractual obligations if an event beyond that party’s control (a “*force majeure*

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event”) occurs. Such a clause may operate to suspend the obligation to perform the contract or even to terminate the contract” (Malleons, 2008).

Force majeure covers a wider class of events than the all too commonly used “act of God” which definition according to Hudson (1995) is, “such an operation of the forces of nature as reasonable foresight and ability could not foresee or reasonably provide against”. This effectively includes events which are caused not only by nature but also takes into consideration any events that are triggered by the human factor such as war, strikes, civil commotions and riots.

Generally, an event will constitute a force majeure when:

- the event is beyond the control of the contracting parties; and

- the event could not have been prevented by the parties despite the exercise of due care.

In determining whether an event is a force majeure event, the contractual definition of force majeure needs to be examined as force majeure clauses may be written either in an inclusive or exclusive way (Malleons, 2008).

An inclusive force majeure definition sets out the criteria in which they must be satisfied together with a non-exhaustive list of examples of such an event, leaving the parties free to interpret or add on events not included in the list. It is a general catch-all term to provide for any other event or effect that cannot be reasonably anticipated or controlled and which is not otherwise expressly included in the contract

An exclusive definition, on the other hand, sets out an exhaustive list of force majeure events. Only those listed events can be construed as force majeure events, which is not open to the parties to interpret or add on any other events as force majeure events. In other words, “everything else is excluded”.

Inclusive definition covers a greater range of events thereby making it potentially easier for the non-performing party to be excused from liability. Exclusive definition of force majeure event, however, limits the circumstances in which the non-performing party can be excused from liability by reason of force majeure.

Sample inclusive and exclusive definitions of force majeure are as shown in Table 1 below.

INCLUSIVE DEFINITION	EXCLUSIVE DEFINITION
<p>Force Majeure Event means any cause outside the reasonable control of the affected party and which could not have been prevented or avoided by that party taking all reasonable steps including:</p> <ul style="list-style-type: none"> • act of God, earthquake, cyclone, fire explosion, flood, landslide, lighting, storm, tempest, drought or meteor; • war (declared or undeclared), invasion, act of a foreign enemy, hostilities between nations, civil insurrection or military usurped power; • act of public enemy, sabotage, malicious damage, terrorism or civil unrest; • ionising radiation or contamination by radioactivity from any nuclear waste or from combustion of nuclear fuel; • confiscation, nationalisation, requisition, expropriation, prohibition, embargo, restraint or damage to property by or under the order of any government or government authority; or • strikes, blockades, lock out or other industrial disputes. 	<p>An Event of Force Majeure is an event or circumstance which is beyond the control and without the fault or negligence of the party affected and which by the exercise of reasonable diligence the party affected was unable to prevent, provided that event or circumstance is limited to the following:</p> <ul style="list-style-type: none"> • riot, war, invasion, act of foreign enemies, hostilities (whether war be declared or not) acts of terrorism, civil war, rebellion, revolution, insurrection of military or usurped power, requisition or compulsory acquisition by any governmental or competent authority; • ionising radiation or contamination, radio activity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel, radioactive toxic explosive or other hazardous properties of any explosive assembly or nuclear component; • pressure waves caused by aircraft or other aerial devices travelling at sonic or supersonic speeds; • earthquakes, flood, fire or other physical natural disaster, but excluding weather conditions regardless of severity; and • strikes at national level or industrial disputes at a national level, or strike or industrial disputes by labour not employed by the affected party, its subcontractors or its suppliers and which affect an essential portion of the Works but excluding any industrial dispute which is specific to the performance of the Works or this Contract

Table 1 – Sample clauses of Inclusive and Exclusive Definition of Force Majeure
(Extracted from Malleons Stephen Jaques 2008, Force Majeure Clauses: Key questions answered)

Force Majeure Clauses

Every project is unique as they differ in terms of conditions and circumstances of the project and the risks involved in each project are obviously different from each other. Therefore the approach in the allocation of the risks should also differ. A *force majeure* clause, in essence is an approach of risk allocation should a force majeure event occur. Careful considerations by the contracting parties is needed on the construction of *force majeure* clauses as the contracting parties may have to rely on such clauses either as the basis of their claim or as a defence against the effect of a force majeure event.

Another area which the contractor needs to pay attention to is the list of events that are to be considered as force majeure events. Risks sharing between the contractor and client can be fairly allocated by considering and including both inclusive and exclusive definitions of force majeure events. By listing down both definitions of *force majeure* events, this draws a clear line between the events or circumstances that can be regarded as force majeure or otherwise.

It is important for contractor to realise the significance of each event that is included in the conditions of contract. If there is any event which the contractor thinks is unexpected but could happen and affect the performance of the contract, he should negotiate with the client to include such an event before the contract is executed. When entering a fixed-price contract, it is even more pertinent that the contractor should foresee or anticipate the unexpected so that the ensuing damages would be

managed and not be too severe when it happened.

Contract Provisions for Force Majeure

All the standard forms of construction contract in Malaysia have the *force majeure* clause in the provision for Extension of Time except PWD 203A (Rev 2007). PWD 203A has an independent *force majeure* clause in addition to a *force majeure* sub clause under the Extension of Time clause.

The existence of a *force majeure* clause in the standard forms of construction contract is to make the contracting parties share the risks of unforeseeable events or circumstances.

Table 2 below shows the relevant clauses in the standard forms of construction contract available in Malaysia.



	PAM 2006	PAM 1998	PWD 203A (Rev.2007)	IEM 1989	CIDB 2000
Force Majeure Clauses	23.8(a)	23.7(i)	43.1(a) & 57	43(a)	24.1(a)

Table 2 – Relevant clauses related to Force majeure

Force Majeure Notice

For the contractor to rely on a *force majeure* event to claim for his entitlement to extension of time, there are strict procedures to adhere to. When a force majeure event or circumstance occurs that will cause or likely to cause delays to the progress of the works, it is pertinent that the contractor gives written notice to the architect/S.O. In failing which, the contractor may not be entitled to claim for extension of time

as such notices can be a condition precedent to his contractual entitlement for extension of time.

PAM 2006 requires, as a condition precedent to the contractor's entitlement to extension of time that, written notice be given within twenty-eight days from the date of:

- the architect's instruction;
- the confirmation of the architect's other forms of instruction; or

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- the commencement of relevant events as stated in Clause 23.8, whichever is the earlier.

PWD 203A, PAM 1998 and IEM 1989 require such notices to be submitted immediately after the occurrence of a force majeure event. It must be noted that CIDB 2000 and PAM 2006 standard forms of contract require the contractor to submit such notices within a specified period.

There is a significant emphasis placed on the effect of *force majeure* in the latest edition of the PWD 203A standard form of contract. This further shows that force majeure is becoming a vital contractual issue and has been given the due attention that it deserves, even in Malaysia.

Table 3 below shows the relevant contract clauses of such requirements under the common standard forms of construction contract in Malaysia.

	PAM 2006	PAM 1998	PWD 203A (Rev.2007)	IEM 1989	CIDB 2000
Notice Clauses	23.1(a) & (b)	23.1	57.3	43	24.2(a)

Table 3 – clauses related to submission of notice for extension of time application

What can be claimed under Force Majeure?

Two important factors need to be considered in deciding whether an event can fall under a *force majeure* event (Quilling 2005). Firstly, the event must be unforeseeable at the time the contract was entered. Secondly, will the event leads to non-performance of the obligations under the contract.

To rely on a force majeure clause, whether to claim for extension of time or to exclude from liability in the event of non-performance, the following general principles of how force majeure clauses will be enforced are pertinent (Mallesons, 2008):

- Burden of proof**
The party who seeks to rely on a force majeure clause will have to prove the occurrence of the event within the said clause.
- Own negligent act or omission**
A party cannot benefit from a force majeure clause if the non-performance was a result of its own negligent act or omission.
- Legal or physical restraint**
The force majeure event must have created a legal or physical restraint and not just an economic or commercial obstacle.

With the exception of PWD 203A, standard forms of construction or building contract in Malaysia only allow *force majeure* to be used for extension of time claims. Without a force majeure clause, contractors will have to complete the works in all circumstances even if delays had been caused by force majeure events which are unforeseeable or beyond the control of the contractors.

PWD 203A takes the application of force majeure a step further where Clause 57.1 permits the contracting parties to be excused from liability for non performance as a result of events or circumstances which are beyond the control of either party and had rendered performance impossible. These events are set out in an exclusive list of 'Events of Force Majeure' in Clause 57.2 and are reproduced below.

Clause 57.2 (PWD 203A Rev 2007)

An "Event of Force Majeure" is an event beyond the control of both Parties which are:

- war (whether declared or not), hostilities, invasion, act of foreign enemies;
- insurrection, revolution, rebellion, military or usurped power, civil war, terrorism;
- natural catastrophe including but not limited to earthquakes, floods, subterranean spontaneous combustion or any operation of the forces of nature against which an experienced contractor could not reasonably have been expected to take precautions;
- nuclear explosion, radioactive or chemical contamination or radiation (unless caused by the negligence act, omission or default of the Contractor, its agents or personnel);
- pressure waves caused by aircraft or other aerial devices traveling at sonic or supersonic speeds; and
- riot, commotion or disorder, unless solely restricted to employees of the Contractor or its personnel, servants or agents.

There are construction contracts used for projects in the international market that further define force majeure events into Natural Force Majeure and Political Force Majeure. An example of these is set out, as follows:



1.0 Natural Force Majeure Event
A "Natural Force Majeure Event"

means a Force Majeure Event which is not a Political Force Majeure Event, including :

- 1.1 lightning, fire, earthquake, flood, cyclone, tornado, tsunami, typhoon or other natural disaster or act of God;
- 1.2 epidemic or plague;
- 1.3 accident, explosion or chemical contamination;
- 1.4 seawater contamination;
- 1.5 strikes, works to rule or go-slows (other than solely by employees of the Affected Party or its Affiliates);
- 1.6 Fuel Supply Failure, Electricity Transmission Facilities Failure or Water Transmission Facilities Failure occurring other than as a result of any of the events under Clauses 2.1 to 2.5: and
- 1.7 any event affecting a Contractor of the Company other than as a result of any event under Clause 2.8.

2.0 Political Force Majeure Event
A "Political Force Majeure Event"
means:

- 2.1 acts of war (whether declared or not), invasion, armed conflict, act of foreign enemy or blockade in each case occurring within Saudi Arabia or involving Saudi Arabia;
- 2.2 acts of rebellion , riot, civil commotion, strikes of a political

nature, ad or campaign of terrorism, or sabotage of a political nature, in each case, occurring within Saudi Arabia:

- 2.3 any boycott, sanction, embargo penalty or other restriction imposed directly on Saudi Arabia by the government of Japan, the Republic of Korea, Malaysia, the United States of America and the member states of the European Union during the period up to and including the latest of
 - (i) the project Commercial Operation Date; or
 - (ii) the expiration of the relevant warranty period stipulated in the EPC Contract or the O&M Contract;
- 2.4 any action or failure to act by a Competent Authority, including any action or failure that results in any Approval:
 - (a) ceasing to remain in full force and effect; or
 - (b) not being issued or renewed in a timely manner upon due application having been made, provided that the proper exercise of any rights of a Competent Authority in response to a Company default under or breach of the terms of any Approval, or any breach of any law by the Company, shall not constitute a Political Force Majeure Event;
- 2.5 a change in Law;

- 2.6 archaeological discoveries or the discovery of hydrocarbons on or within the Sites;
- 2.7 Fuel Supply Failure, Electricity Transmission System failure or Water Transmission facilities Failure to the extent such failure is caused by any of the events under Clauses 2.1 to 2.5: and
- 2.8 an event under Clauses 2.1 to 2.7 affecting a Contractor of the Company.

It must be noted that neither the employer nor the contractor has any control over the occurrence of a *force majeure* event. Except for the entitlement of an extension of time, these neutral *force majeure* events usually do not entitle the contractor to reimbursement of any loss and/or expense incurred. The financial burden or consequences of any delays caused by these neutral events are usually shared by both parties.

The following are legal cases where ligations on matters other than delays and extension of time were made based on the *force majeure* doctrine:

Berney v Tronoh Mines Ltd.(1949)

The contract of service of plaintiff was discharged by frustration due to the Japanese invasion of Malaya during WWII. The court ruled that there was no breach of contract by the defendants due to the invasion which is one of force majeure events.

Penang Development Corporation v Teoh Eng Huat (1992)

The corporation had relied on the argument that the government policy in support of Bumiputera contractors had delayed the completion of a

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housing project. The court held that such government policies do not constitute force majeure and the respondent purchasers were successful in their claim for damages of late delivery.

Can Price Escalation be a Force Majeure Event?

In the construction industry, contractors often tend to think lightly of the risks involved with fixed-price contracts during tender stage until it's too late after the award of the contract. Fixed-price contracts can be financially hazardous when unexpected surges or escalation in cost of materials, such as steel, cement, bitumen and diesel, change the assumptions on which the contract price is based, thereby increasing the cost to perform the contract effectively.

Unlike contracts with fluctuation of price clauses, where changes in cost of materials are compensated for, fixed or firm price contracts disallow the contractors to claim for any fluctuation in costs or prices of materials. The substantial increases in steel prices over the past couple of years and recent decreases bear testimony to such price fluctuations. Risks of price escalation of materials

often rest solely upon the contractor unless they are passed on to the subcontractors and/ or suppliers.

Price escalation, particularly those of substantial or significant impact, in most cases is an unforeseeable event and can result in non-performance of the contract thus satisfying the two factors of *force majeure*. Therefore, is price escalation a force majeure event?

Perhaps the question is, how would the price escalation leads to non-performance of the work?

There are a variety of reasons for material price increases such as local and global demand, shortages and/or regulative restrictions of supply, dwindling of resources, country's currency strength, etc. Unforeseen material price increases, which can be substantial, will adversely affect profit margins and/or cause significant losses in an otherwise profitable venture. This may lead to non-performance, but it is merely a case of the contract being unprofitable to perform or has become more expensive to perform. Therefore, increased costs alone do not excuse non-performance. In fixed-price contracts, the contractor

is considered to have assumed the risks of material price escalation, unless there is an express provision to shift the risk such as a price fluctuation clause.

Generally, the courts do not view price increases as force majeure events, even if they are unforeseeable at the time the contract was entered and/or they then lead to non-performance of the obligations under the contract. Most price escalation claims argued on the basis of force majeure have been rejected by the courts.

Force majeure clauses may enable a contractor additional time to perform but will not provide relief to him if he is forced to pay higher material prices than was originally estimated resulting in loss of profits or a much more costlier contract to complete.

Without a price fluctuation clause, a contractor will face a near impossible task to seek relief if there is an unexpected escalation in prices of construction materials. A contract which has become uneconomical to perform is insufficient to excuse non-performance.

However, if the escalated costs occur during an extended period when the project would have been completed if not for the delaying event, the courts of arbitration or litigation may be sympathetic towards such claims.

In the absence of any expressly stated price escalation or cost fluctuation provisions, it would seem difficult to make such claim valid and admissible. Under such circumstances, there are, however,

apart from *force majeure*, other possible contractual and/or legal avenues such as impossibility, commercial impracticability and frustration, if the contractor wants to consider to be excused from their contractual performance (see: "*Construction Contracts - Controlling Escalation Costs*" Legally Speaking Bob Dunlevey at www.dmfdayton.com & "*When the price of materials skyrockets, what can a contractor do?*" - David Bicknell at www.bicknell-law.com "*Sharing the Risk*" - Sachin Kerur at www.fidic.org).

These other possible legal remedies on the basis of impossibility, commercial impracticability and frustration of purpose, briefly described below, may not be available if a special clause is not included in the contract to allow for such remedies, although it can be argued that they may be possible under common law.

Impossibility

A party can be excused from their contractual performance when due to an unexpected event; the performance has become impossible, not uneconomical.

Commercial Impracticability

Due to an unexpected change, the performance need not be impossible but rather extremely impractical, costly, time consuming or when all alternative means have been exhausted.

Frustration

Arises when a change in circumstances due to an unforeseen or supervening event rendering the performance one party's performance virtually worthless to the other.

However, it must be noted that such provisions are usually included to protect the parties if the contract or part of it cannot be performed due to an exceptional event beyond the control of the parties and cannot be prevented with reasonable care.

Further, whilst such provisions may allow for time extension for performance, they are unlikely to allow for price escalation or increased costs to be admissible without the necessary justifications.

Notwithstanding, whilst a majority of the courts, particularly in the common law jurisdictions, have refused to excuse performance based on drastic price escalation causing a contract to be unprofitable, under the laws in many Arab countries, influenced by Islamic law, which is founded on equity, such adjustment of the contract price may be possible where the contractor is affected by such severe and unforeseeable condition or extreme change in circumstance.

Similarly, in many civil law cases, adjustment of the contract price is allowed even though a contract may not contain such price escalation or cost fluctuation clause when faced with unforeseeable or exceptional loss (*See Can a Contractor Obtain Compensation for Radical Increase in its Costs if a Construction Contract Contains No Price Escalation Clause* *é Christopher R. Seppala, Elizabert Lefebvre-Gross*)

Summary/Conclusion

Force majeure defined as any events or circumstances that are beyond the control of man which either hinder or prevent the

performance of work despite the exercise of due care, covers a wider class of events than just "act of God", as it includes events which are caused not only by nature but also takes into consideration any events that are triggered by the human factor such as war, strikes, civil commotions and riots.

A *Force majeure* clause, in essence is an approach of risk allocation should a *force majeure* event occur. Careful considerations by the contracting parties is needed on the construction of *force majeure* clauses as the contracting parties may have to rely on such clauses either as the basis of their claim or as a defence against the effect of a *force majeure* event.

Force majeure is a frequently cited event that is used to excuse non-performance due to unforeseen or exceptional events beyond the control of the contracting parties. Such events included price fluctuation, particularly when recent drastic price and cost increases in construction materials rendered a construction contract uneconomical or unprofitable.

However, it is trite law that many common law courts have refused to excuse the contractor from performance or allow for price escalation in fixed priced contract due to price or cost increases, merely because it has become not profitable or difficult to perform. Generally, the courts do not see price escalation or cost increases, even when drastic, to be unforeseen.

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In the next issue of the MBAM journal the article will answer the question on "***What is the Difference between Patent and Latent Defects ?***"



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For further details, please visit website: www.entrust.com or contact HT Ong at 22-1 & 2 Jalan 2/109E, Desa Business Park, Taman Desa, 58100 Kuala Lumpur, Malaysia. Tel: 6(03)-7982 2123 Fax: 6(03)-7982 3122 Email: enquiry@entrust.com.my

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