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Covid-19 and commercial contracts - a guide

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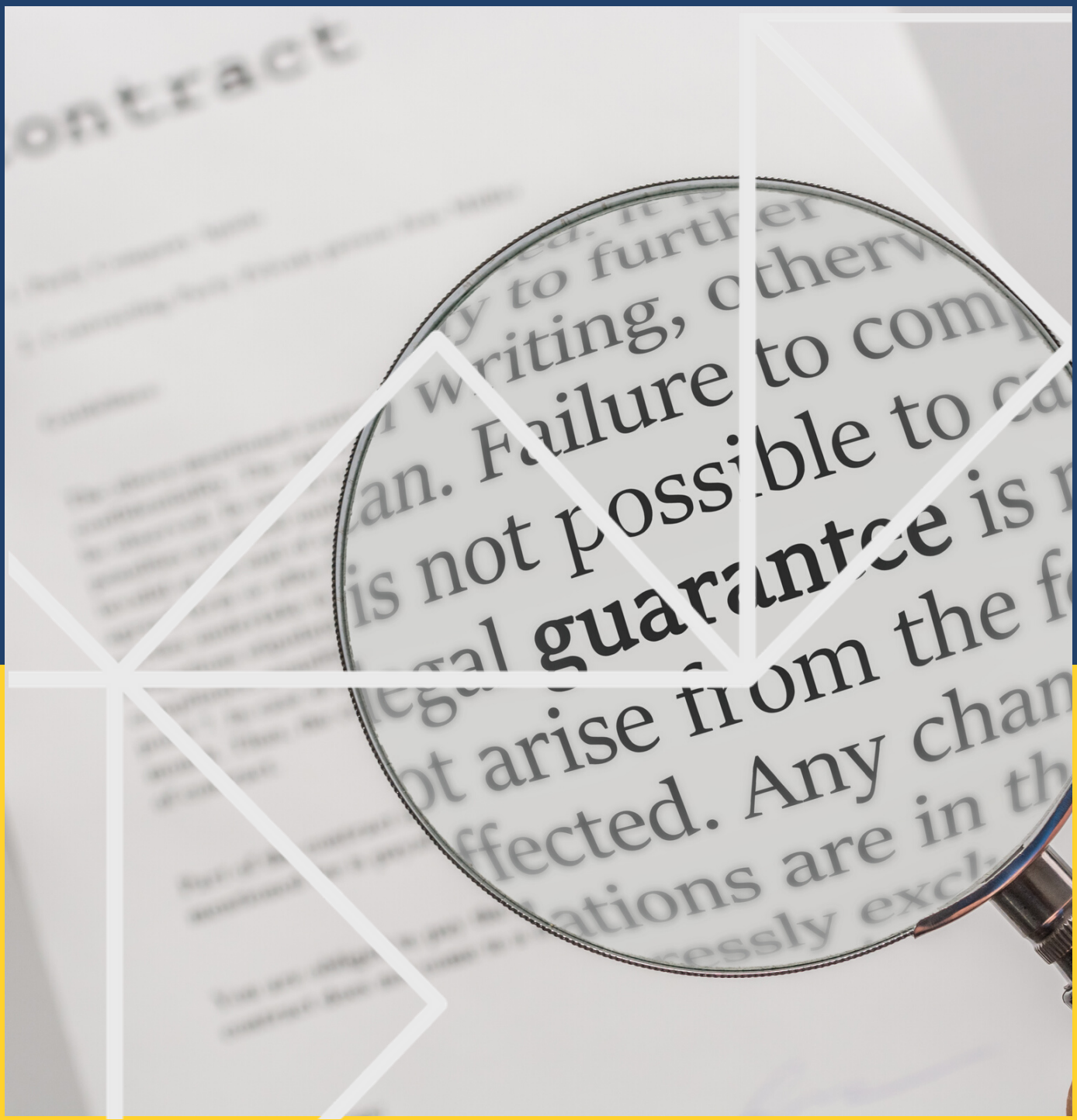

COVID and Commercial Contracts

The Covid-19 pandemic is likely to lead to a wave of disputes as to which party bears the risks of non-performance. There are some key principles which commercial parties should consider in order to assess the likely outcome of any dispute before risking litigation.

This guide covers some of the main points and is split into five sections:

- Force majeure
- Frustration
- Suppliers
- Traders selling to consumers
- Material Adverse Change

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Force majeure

Can I deem the COVID pandemic to be a force majeure event?

English law has no general rule of force majeure and so whether the Covid-19 outbreak is a force majeure event will depend on the drafting and interpretation of each specific contract. Therefore, you will need to consider the following:

(i) Does the contract include a clause (which need not be labelled "force majeure") which anticipates that there may be some sort of supervening event beyond the control of the parties that may affect the performance of a contract, and which provides contractual relief for one or both parties from performance of some or all of their obligations as a result?

(ii) Does the contract's concept of force majeure event as drafted apply to the Covid-19 crisis? Some clauses will specifically refer to 'epidemics', 'pandemics', 'diseases', 'action taken by Government imposing a restriction' or 'non-performance by suppliers or contractors'. Be careful as even if there clearly was a force majeure event, its effect will depend on the facts, i.e. did the event actually prevent, hinder or delay a party from performing an obligation?

(iii) The general language of "Act of God" is said to mean "such a direct and violent and sudden and irresistible act of Nature as the defendant could not, by any amount of ability, foresee would happen, or, if he could foresee that it would happen, he could not by any amount of care and skill resist, so as to prevent its effect". A pandemic, which involves no human agency, may well sit within such meaning.

What is the effect of invoking a force majeure provision?

Typically, if a force majeure event occurs, common provisions may:

(i) Excuse one or both parties from performing the contract, in whole or in part; or

(ii) Allow one or both parties to suspend or defer performance.

Force majeure (cont.)

Note that in most contracts, the affected party will also need to show that the force majeure trigger has prevented, delayed or hindered its performance. Other common provisions may require the affected party to:

(i) Take reasonable steps to avoid or mitigate the event or its consequences.

(ii) Notify the other party and keep it informed.

What if we don't have a force majeure clause?

If the contract lacks a force majeure clause, no particular relief will necessarily flow from situations the parties might consider force majeure and so a party who is now unable to perform may be in breach of contract, even if the party is not morally to blame. Fault is not a requirement for breach, unless the contract says it is. If the failure to perform is a breach, it will normally give the other party the right to claim damages, and possibly also the right to terminate.

Frustration

'Has the contract been frustrated by the COVID pandemic?

It may be that the contract has been 'frustrated' as a result of the COVID pandemic such that performance of the contract has become legally or physically impossible through no fault of the parties. Frustration occurs whenever the law recognizes that "without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract". In practice, it is unusual to see a contract frustrated in law and the last time multiple contracts were frustrated was during WW2 when it became legally impossible to trade with the enemy. However, it is worth considering as an option as a frustrated contract ends automatically and immediately, without any action by the parties, who then have only limited rights of redress.

Cases on frustration broadly fall into three subcategories:

(i) impossibility of agreed performance;

(ii) the mutually agreed purpose of the contract becoming impossible (i.e. impossibility of the "commercial adventure"); and

(iii) a significant change to a mutually agreed state of affairs (i.e. destruction of the subject matter of the contract or cancellation of an event).

If contract performance has become illegal due to the COVID pandemic, is the contract frustrated?

If some aspect of performance of a contract has become a crime (or something very close to a crime), then public policy will not allow a party to enforce it through the courts. So, for example, a party could not get an injunction to compel performance of an illegal act, or claim damages for the failure to perform it. The same public policy affects payment duties triggered by illegal acts and, in principle, could affect a payment duty triggered by the failure to perform an illegal obligation. If performance of a contract has become legally or physically impossible then the contract is frustrated. However, note that a contract is not frustrated if:

(i) a valid contract term deals with the situation; or
(ii) the parties should have foreseen (or actually did foresee) the frustrating event, when they made the contract.

Suppliers

What if, as a supplier, I can deliver but my customer no longer needs the service or goods?

Force majeure clauses don't normally automatically excuse both parties from all liability, or bring the contract automatically to an end.

It is important to take each party in turn and consider their respective obligations. Typically, a customer's main obligation is to pay the price for the service (or goods) that the supplier provides, and they are also subject to an implied term that they must not actively prevent the supplier from carrying out its obligations. Therefore, you should consider:

(i) Does the pandemic prevent your customer from paying for the service?

(ii) Does the pandemic prevent your customer from doing something that must be done before you, as the supplier, can provide the service? For example, the Government has required your customer to close its premises, where you need access to provide the service.

Even if you may be physically able to deliver the service, you may be able to argue that it is no longer legal nor possible to do so.

Could we simply suspend performance of the contract?

There is no general right to suspend performance just because the other party is failing to perform its obligations – unless there is a specific clause which provides for this. It is of course open to either party to approach the other to request a suspension by way of an agreed variation. Otherwise, if, without frustration or any excuse under the contract terms a party stops performance, that is a breach of contract. The breach may trigger termination rights under the contract and the non-defaulting party could claim as damages all its losses caused by the breach and maybe also its losses following from a justified termination.

Suppliers (cont.)

Could I just abandon a contract which becomes too hard or expensive to perform?

Unless the contract is actually frustrated, as a general rule even if performance of a contract becomes more difficult or expensive (or even unprofitable), the party who fails to perform is in breach and must pay damages. Even if abandoning the contract is not yet a breach (because no obligations are currently due), the other party could formally accept the abandonment as a 'repudiation' of the contract, end the contract, and claim damages for all its loss caused by the termination. Note that walking away from a contract might be deliberate or wilful default, or wilful abandonment and under some exclusion or limitation of liability clauses, there is no limit on damages for this kind of default.

Could I terminate the contract?

A party can only terminate if it has a contractual right to do so. Relevant contractual termination rights in light of the Covid-19 emergency will include any right to terminate on notice, and those relating to the solvency of the other party, a prolonged period of suspension, a prolonged force majeure event or the prolonged effect of Government intervention. Ensure that you have a clear right to terminate as wrongful termination constitutes a 'repudiatory' breach of contract by the terminating party, the financial consequences of which are usually significant.

Can we vary the contract or renegotiate its terms?

To the extent that the parties can keep their contract on track and avoid bringing claims against each other, this may be the optimum solution in the current climate. However, this may not always be possible. If parties do agree to vary or renegotiate the terms of their contract, they should comply with any relevant requirements of the contract,such as recording any variation in writing and ensuring other related documents are aligned as necessary.

Suppliers (cont.)

As a supplier, could I be forced to perform the services/deliver the goods?

As a general rule, the law will not compel a supplier to continue or recommence performing services it has contracted to deliver. That is because damages are the primary remedy for a breach of contract. The equitable remedies of specific performance and injunction are only available when damages are not an adequate remedy. Even when a court grants an injunction, most often it is a negative injunction to restrain a party from actions that would breach the contract, and the customer can only get an injunction or specific performance by taking the supplier to court, which is an expensive procedure and bad for business relations.

Traders selling to consumers

What if I am a trader dealing with consumers?

Unlike with business relationships, the ability to exclude or limit liability for breach of commitment as to time for performance is strictly controlled when servicing consumers. Terms governing when goods, digital content and services must be delivered will generally form part of the contract, under the Consumer Rights Act 2015 (CRA) and the Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013 (SI 2013/3134) (CCRs). The CRA provides remedies for breach of these terms and a trader cannot exclude and, save in the case of services, cannot limit its liability for such a breach. Any contract terms which attempt to prevent or discourage a consumer from exercising their statutory rights are also void.

However, the CMA Unfair Terms Guidance suggests that it may be considered fair to include a provision which seeks to limit liability for delays unavoidably caused by circumstances outside its control (but not events such as shortage of stock, strikes by trader's staff, non-performance by trader's contractors etc). The CMA Unfair Terms Guidance states that clauses excluding liability for delay are more likely to be regarded as fair and thus to be enforceable where:

(i) The trader takes reasonable steps to prevent or minimise delay.

(ii) If there is a risk of substantial delay, the consumer is given a penalty-free right to terminate.

Notes:

Changing Delivery Dates: Under the CCRs a delivery or performance date, as notified to the consumer, can only be varied with the customer's express agreement. Of course the parties could expressly agree, by exchanging emails, on a different time of delivery of the goods than the one agreed but a term in the contract which allowed the trader to make changes unilaterally would not be sufficient.

Rescheduling Goods: Unless delivery of goods by the initial deadline was "essential", then the consumer's remedy for non-delivery is to set a new deadline for delivery (which, if missed, will give the consumer the right to treat the contract as at an end). Any new deadline must be "appropriate in the circumstances".

Traders selling to consumers (cont.)

Rescheduling Services: A consumer's initial remedy where the deadline for performance of services is missed is to ask for repeat performance. If repeat performance is impossible or the trader is in breach of the requirement to do it within a reasonable time and without significant inconvenience to the consumer, then the consumer can move to the remedy of a price reduction. However, where a service is 'time-specific', repeat performance is deemed not possible.

Consumer's Right to Cancel: If there is a delay in performing the contract, a consumer may simply exercise their cancellation right and seek a full refund. Under the CCRs, a consumer who has bought online or otherwise at a distance or off-premises can cancel most contracts. The cancellation period runs from the time of the consumer's order to 14 days from delivery of goods or from contract conclusion for digital content or services. Special rules govern the supply of digital content and services during the cancellation period and the delivery of multiple lots of goods or goods which are regularly delivered.

Frustration: A consumer contract may be frustrated in the same way as a business-to-business contract. Broadly, if the contract is frustrated, the consumer could recover any money paid in advance for products not received, subject to the trader's right to retain expenses. Note that if the consumer has received an unpaid-for benefit under the contract it may have to pay a "just" amount for it.

Therefore, as a trader, if you anticipate missing a deadline, you should therefore promptly notify the consumer, propose a new delivery date range, citing any reasonable circumstances which are affecting you and seek the consumer's acceptance of it. Generally good communication with consumers is likely to reduce disputes. However, be careful not to mislead the consumer about any right they may have to treat the contract as at an end, as this is an unfair commercial practice.

Material Adverse Change

In some types of contracts/agreements it is common to see a **Material Adverse Change** or **MAC** clause to deal with one party's significant and damaging changes in commercial circumstances. This is particularly the case in financing documentation (such as facility agreements) where the lender has agreed to advance further funds in the future, and also in corporate transactions where the parties have agreed to split exchange and completion and accept an interim period during which the buyer will be contractually committed to purchase whilst the seller retains ownership and control.

MAC clauses are normally bespoke and specific to the business sector, so the drafting can vary significantly from contract to contract. This means that, regardless of the type of contract, the court's interpretation of any individual MAC clause will be very fact-specific and language-specific, and so each clause must be assessed carefully on its own wording. Any party seeking to rely on the MAC clause will have a heavy burden to prove to a court that there is sufficient evidence that a MAC has occurred and, historically, English courts have interpreted MAC clauses on only a handful of occasions, meaning there is some uncertainty as to the likely outcome in the event of litigation.

It is fair to say that relying on MAC clauses can be a risky business. The stakes are high as if a party (Party A) gets it wrong and refuses to fulfil its obligations to the other party (Party B) or calls an event of default on Party B when not entitled to do so, Party A risks becoming liable for a repudiatory breach of contract. On the other hand, if Party A decides not to exercise MAC clause rights in circumstances where Party B's position has deteriorated and continues to do so, Party A may end up substantially out of pocket should Party B enter administration or insolvent liquidation.

In order to assess the effect of any Material Adverse Change clause within your contracts and be able to make an informed decision as to what action may be available, you should ask the following key questions:

Material Adverse Change (cont.)

Has the coronavirus outbreak resulted in a Material Adverse Change?

What 'Material Adverse Change' means for you will depend on how it is defined in your contract. Unless the MAC clause specifically references a '*pandemic*' (or equivalent wording), the fact that we are in the midst of a pandemic is not likely to be considered a MAC in itself; however, it is possible that the impact of the pandemic on a party's financial position, or the impact of the Government's actions (for instance a party not being able to lawfully carry out its business due to the business closure requirements) could technically lead to a MAC.

Has the change in market conditions triggered a Material Adverse Change?

It is suggested that, in finance arrangements, where a lender knows that its borrower intends to generate the funds necessary to repay a loan through trading but the borrower's ability to trade has been significantly curtailed if not stopped altogether by Covid-19, this may of itself constitute a MAC to the borrower's financial condition. However, since each clause is interpreted on its own language, if the drafting does not include '*prospects*' or '*external/market conditions*', it is unlikely that a party will be able to rely on this type of unanticipated change in market conditions if it is seeking to enforce the MAC clause.

What counts as 'material'?

As the name suggests, to rely on a MAC clause, the event must be 'material'. This means that it must be substantial, significant and for a significant period of time. If it is only temporary or a blip, it will not be sufficient to constitute a MAC. Parties may face a challenge in demonstrating that with the coronavirus outbreak, the change is long term as opposed to temporary and recoverable; whilst the period of impact is unknown, we do not expect it to last forever. Again, the wording of the clause itself is critical; for example, in finance documents a change is likely to only be considered material if such change directly impacts the borrower's ability to repay monies.

Material Adverse Change (cont.)

What is the effect of a Material Adverse Change clause?

Typically, MAC clauses operate to alter the situation between the parties in the event that something significant happens to affect the circumstances or one or other party. For example, in a corporate transaction a MAC event may give the buyer the ability to walk away from a deal, and in a finance context may give a lender the ability to prevent further drawdown of funds.

What if the other party disagrees that there is a Material Adverse Change?

It is worth noting that if Party A relies on a MAC clause and takes action (for example if Party A as a lender refuses to advance further sums that they are obliged to advance, assuming Party B, as the borrowing party, is compliant in all other areas), and it is later proven that there had not been a MAC event, Party A relying on the clause would be in breach of contract, and Party B would have a claim for damages, which could involve significant compensation.

It is important to bear in mind the risk of adverse publicity and the impact on the parties' relationship during this time, as the general consensus amongst businesses seems to be a desire to be supportive through the coronavirus outbreak. Overall, the risk of enforcing a MAC clause in these circumstances is high for the party seeking to rely on it and it is usually recommended to have early conversations with the other party in order to understand their thoughts and position with regard to the operation of the contract and continued dealings.

As a general rule, MAC clauses are seen as a catch-all concept - a 'contractual fallback' which helps a party to bring the other party back to the table during a downturn, rather than being used as a cause of action on their own. As mentioned above, there is very limited case law around MAC clauses, showing that whilst they are often included in financing and corporate agreements, they are rarely litigated. In particular, there is no case law around the effectiveness of MAC clauses during a pandemic and given the fast-paced nature of the current crisis and how quickly things progress, the position may change rapidly leaving you exposed in terms of any steps taken in haste.