

COVID-19: PRESSURE POINTS: WILL THIS BE A VALID BASIS FOR AVOIDING CONTRACTUAL OBLIGATIONS? (UK)

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Legal Briefings - By **Natasha Johnson, Robert Moore, Yasmin Mitha, Artjom Buligin, Danil Guryanov, Maria Dolotova and Anna Sokolova**

With the continuing rise in the number of cases of COVID-19 worldwide declared to be a pandemic by WHO, in addition to obvious implications of the outbreak for individuals, businesses are likely to be exposed to a heightened risk of legal implications arising across their supply chain.

As well as the significant human cost, the economic cost is mounting. The virus will ultimately impact almost every sector due to supply chain issues and suppressed demand resulting from uncertainty, travel restrictions and general disruption to 'business as usual'. This is reflected in the performance of the global financial markets, which have suffered significant losses since the outbreak of the virus, the quickly dropping oil prices and the recent surge in the price of gold, reflecting investor nervousness.

We expect to see (and, in some instances, have already seen) businesses exposed to a heightened risk of legal implications arising across their supply chain.

In particular, counterparties may seek to delay and/or avoid performance (or liability for non-performance) of their contractual obligations and/or terminate contracts, either because COVID-19 has legitimately prevented them from performing their contractual obligations, or because they are seeking to use it as an excuse to extricate themselves from a bad deal.

Parties may also cite COVID-19 as a basis for renegotiation of price or other key contractual provisions (eg volume of materials exported from or imported into affected areas due to shifts in supply and demand).

The spread of COVID-19 may also trigger conflict with other legal obligations, such as employers reconciling the steps they need to take to ensure business continuity with their duty of care towards their employees.

POSSIBLE BASES FOR AVOIDING CONTRACTUAL OBLIGATIONS UNDER ENGLISH LAW

English law offers a limited range of remedies for avoiding contractual obligations where a contract becomes difficult or impossible to perform. Two such remedies are (1) the common law doctrine of frustration; and (2) the presence of a contractual force majeure clause.

FRUSTRATION

- At common law the doctrine of frustration will operate to terminate a contract automatically when a subsequent event occurs, which is (1) unexpected; (2) beyond the control of the parties; and (3) makes performance impossible, or renders the relevant obligations radically different from those contemplated by the parties at the time of contracting.
- In a 2003 SARS epidemic-related case *Li Ching Wing v Xuan Yi Xiong* [2004] 1 HKLRD 754, a Hong Kong court rejected a tenant's claim that a tenancy agreement was frustrated because the premises were affected by an isolation order by the Department of Health due to the outbreak of SARS, which meant that it could not be inhabited for 10 days. The court held that a 10 day period was insignificant in view of the two-year duration of the lease, and that whilst SARS was arguably an unforeseeable event, it did not "significantly change the nature of the outstanding contractual rights or obligations" of the parties in the case.

However, that is not to say that an epidemic or pandemic, or events associated with it, cannot amount to frustration. No doubt they can, so long as they render performance impossible or illegal or "radically different". Given the dramatic impact of the Covid-19 pandemic, there would appear to be scope for the doctrine of frustration to apply in many cases, depending on all the circumstances.

- A party might seek to argue one or more of the following established grounds operate to found a claim that a contract has been frustrated by the COVID-19 outbreak:

- Temporary unavailability – a person (or object) that is essential for performance of the contract is temporarily unavailable. This would most obviously frustrate a contract, where the contractual terms dictate that it was to be performed only at, or within a specified time period, and that the time of performance was the essence of the contract;
- Failure of a specific source – if the subject matter of the contract is to be obtained from a specific source, which becomes unavailable due to no fault of either party. Case law suggests that this could arise, if goods are extracted from a particular crop which fails due to drought or disease; or where goods are to be imported from a particular country, where import is prevented by factors beyond the parties' control (eg war, natural disasters, or prohibition of export);
- Method of performance impossible – if the contract provides a method of performance which becomes impossible. However, the courts have held that a contract will not be frustrated where performance is possible by a different method, and the difference between the two methods of performance is not sufficiently fundamental;
- Illegality – if the contract becomes illegal as a result of changes in law. This could be relevant in light of the emergency legislation introduced to deal with the pandemic.

It is possible to see how parties might seek to make these sorts of arguments given the scale and impact of the virus in many countries. Ultimately, whether a party would be successful before the English courts would depend on the facts of the case, including as to whether in the particular circumstances performance is rendered impossible or radically different from what was envisaged. It is important to keep in mind that the courts have tended to apply the doctrine of frustration narrowly, emphasising that it is not likely to be invoked to allow a contracting party to escape from what has turned out to be a bad bargain.

If successful, the effect of frustration is automatic termination of the contract. The Law Reform (Frustrated Contracts) Act 1943 provides that parties are able to recover monies paid under the contract before it was discharged (subject to an allowance for expenses incurred by the other party at the court's discretion).

FORCE MAJEURE

As a practical matter, given the limited applicability of the doctrine of frustration, parties will often include a force majeure clause in their contracts. Such clauses excuse one (or both) parties to a contract from performance of their obligations following the occurrence of unexpected events or circumstances which are outside of that party's control.

A typical force majeure clause will provide that a party is excused where it is prevented (or hindered or delayed) from performing its obligations due to the occurrence of an event beyond the reasonable control of the parties. The contract may include a list of such events, by way of example or exhaustively, eg an Act of God, war or conflict. Where the clause sets out a list of events, it may well include a pandemic, typically by reference to classification by the World Health Organisation (and of course COVID-19 has been classified as such). Other common categories of force majeure event that may be triggered by the COVID-19 crisis in particular circumstances include changes in law or regulation, acts of governmental authorities, the restriction or suspension of licences etc, and delays in transportation or communications. In any event, if (as is typical) there is a general “wrap-up” provision for events beyond a party’s control, the COVID-19 pandemic could trigger the clause even if it is not covered by any of the specific categories listed. What is covered will therefore depend on the precise drafting of the clause.

As an example, the China Council for the Promotion of International Trade (CCPIT), a quasi-governmental foreign trade and investment promotion agency, has encouraged businesses that have failed to perform on time or failed to fulfil an obligation in an international trade contract, to apply for a “force majeure certificate”. These seek to “exonerate[] companies from not performing or partially performing contractual duties by proving they are suffering from circumstances beyond their control, which can prove that there were objective facts such as delayed resumption of work, traffic control, and restricted dispatch of labor personnel.” The CCPIT has reportedly issued over 1,600 such certificates, seeking to shield Chinese companies from legal claims.

However, whilst such a certificate may assist evidentially, it will not automatically trigger force majeure contractual provisions. Indeed, a number of international businesses have reportedly already rejected such certificates from Chinese importers seeking relief from taking delivery of liquefied natural gas cargoes.

Whether a party would be successful before the English courts will ultimately depend on the impact of COVID-19 on the performance of the contractual obligations; and the precise wording of the contract and specific force majeure clause (eg as to whether the relevant triggering event must “prevent” performance or meet the lower standard of “hinder” or “delay”). Given the fact-specific nature, this is likely to result in disputes.

It is important to note that a change in economic or market circumstances which makes the contract less profitable or performance more onerous is not generally regarded as sufficient to trigger a force majeure clause. So if, despite the COVID-19 pandemic, both parties remain able to fulfil their contractual obligations, the situation will not be one of force majeure, even if the contract has become less profitable for one of the parties perhaps because of market circumstances resulting from the pandemic. If however a party is prevented from performing, eg because of emergency legislation introduced to deal with the pandemic, this may well lead to a valid claim of force majeure.

Depending on how it is drafted, successful reliance on a force majeure clause may have some of all of the following consequences:

- Entitlement to suspend performance while the force majeure event continues;
- Non-liability for the non-performance or delay in performance while the force majeure event continues;
- Extensions of any deadlines under the contract while the event continues (eg for completion of a project);
- An express or implied obligation to mitigate, whereby the party seeking to rely on the clause must show that it has taken all possible steps to avoid the event or the impact of its consequences;
- A right to terminate the contract if the force majeure event continues for a specified period.

OTHER CONSEQUENCES FOR CONTRACTS

COVID-19 may also give rise to attempts by counterparties to invoke other contractual provisions, for example:

- Price adjustment clauses - parties may seek to adjust all or part of the contract price for a commodity due to increased costs (eg due to increased supply chain strain) as a result of COVID-19.
- Limitation or exclusion clauses - parties may increasingly seek to rely upon limitation or exclusion clauses (especially in the absence/inapplicability of a force majeure clause) to limit or exclude liability for non-performance.
- Change of law clauses - a party could rely on a “change of law” clause in a contract (entitling either party to terminate or renegotiate the contract, where a change in the applicable law makes it impracticable or impossible for a party to perform its contractual obligations).
- Material adverse change (MAC) clauses – the outbreak of COVID-19 could trigger a MAC clause in a contract. A MAC clause is a term found in some agreements which allows a party to refuse to proceed if certain events occur after the contract date. Whether events related to the COVID-19 pandemic will amount to a MAC will depend on the terms of the clause and the specific circumstances. It may be possible to invoke a MAC clause if events have taken an unexpected turn, after the contract was entered into, which has had a dramatic impact in the particular circumstances of the transaction. Given the

extreme circumstances resulting from the COVID-19 pandemic in many areas, this may be an available line of argument, but it will all depend on the circumstances. Given the fact-specific nature of the enquiry, previous case law is of limited assistance in determining the outcome of a future case, which will turn on the wording of a different clause agreed against different background facts, and the different circumstances alleged to constitute a MAC.

CONTRACT TERMINATION

Where a contract has become uneconomic or undesirable as a result of the COVID-19 crisis, a party may wish to limit its losses by terminating the contract. In these circumstances, it will be important to consider the express termination provisions under the contract and the entitlement to terminate under the common law as a result of the counterparty's breach.

EXPRESS TERMINATION PROVISIONS

The right to terminate under an express termination provision depends on the exact wording of the provision in question. Is there, for example, a right for one or both parties to terminate on notice and without cause? Or are there specific termination rights for one or both parties that are triggered in the circumstances that have arisen (putting aside force majeure or MAC provisions, which are considered above)? If so, then the entitlement to terminate will be relatively clear cut.

The termination clause may also specify particular consequences of termination. For example, it may provide for the return (or retention) of any advance payments, and may include a liquidated damages provision or a limitation or exclusion clause.

TERMINATION AT COMMON LAW

Regardless of whether the contract contains express termination provisions, a party may be entitled to terminate under the common law as a result of the counterparty's breach.

There will be a right to terminate if the counterparty is in repudiatory breach of contract (ie if the effect of the breach is to deprive the innocent party of substantially the whole benefit of the contract) or has clearly demonstrated an intention not to perform the contract in some essential respect.

OTHER CONSEQUENCES FOR BUSINESSES

COVID-19 may also have the following consequences for businesses, potentially also giving rise to conflict with their contractual obligations:

- Employer duty of care – employers are responsible for health and safety management,

and are required to do whatever is reasonably practicable to protect the health, safety and welfare of their employees and other people who might be affected by their business. This means that employers must take proportionate action to protect employees, which may include cancelling work trips to areas affected by the virus; and otherwise protecting the safety of their employees. Failure to do so could expose the business to negligence or health and safety related claims, and could invalidate insurance policies.

- Disruption to supply chain logistics - if existing supply chains fail or are significantly impacted, businesses will be forced to find alternative solutions. Reports suggest a major automotive manufacturer is flying components to its factories in suitcases.
- Distress/Insolvency - the spread of COVID-19 has already resulted in an increase in companies experiencing financial distress as they try to mitigate the financial impacts of supply chain issues coupled with lower customer demand. Companies with already high debt levels are finding existing credit lines withdrawn at a time when they are needing to pay suppliers who are able to deliver on time while not receiving customer payments. We have already seen companies file for Chapter 11 protection, citing COVID-19 as contributing to supply chain problems (see, for example, the recent bankruptcy filing of Valeritas Holdings Inc.). Likewise, planned refinancing and distressed M&A activity is being delayed (as a result of travel restrictions and other measures), with the result that companies are finding it more challenging to execute and implement time critical turnaround plans. As a result, companies may be forced to seek formal and informal protection from their creditors and we expect to see, in more distressed cases, increased insolvency on the horizon.

[More on navigating the COVID-19 outbreak](#)

[Read more on our Litigation notes blog](#)

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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