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CONTRACTS – WHERE YOU STAND WITH COVID-19

Overview

This article looks at the contractual implications of the virus. Is it force majeure? Can good faith be invoked to preserve some of the bargains? How about frustration? This article provides practical guidance to allow accountancy firms and their clients to understand what they can do (and what they cannot) during this pandemic. What must be paid, what is open for negotiation, and when and how to terminate a contract.

The information presented throughout is based on law in England and Wales, although the corresponding rules in Scotland, Northern Ireland and the Republic of Ireland are broadly similar or have a similar effect.

The article has been produced with the assistance of Knights plc, a UK listed law firm with 15 offices across the UK. They have extensive experience supporting both large and small businesses with a full suite of legal services.

Triage

Many businesses have been significantly impacted by Covid-19 and are considering their impact on the current and future contracts. As we discuss below, it is helpful for all businesses to review material contracts and assess what impact Covid-19 has had or might have going forward. This triage process will vary for different businesses and industries but is likely that there will be some significant impact which needs addressing.

The starting point should always be for suppliers and customers to communicate to work through any solutions and find an acceptable way forward. Contracts can usually be renegotiated or varied with consent from both parties – something which may be advantageous to retain supplier and customer goodwill in the long run.

Contract Options

Force Majeure

Force majeure clauses typically allow suspension of contractual obligations whilst the event which caused force majeure continues. The suspension may be time limited and may also allow the parties to terminate the contract if the force majeure event continues for a specified time.

Under English and Scottish law, force majeure only applies if it is included in a contract as it is not part of common law. If it is not written into the contract then this is not an option to be used by either party, although at common law the contracts might still be frustrated, as discussed below.

Force majeure clauses may in some cases also allow parties to alter or cancel their obligations or liabilities under a contract if an event outside their control prevents these obligations or liabilities being fulfilled.

The drafting of a force majeure clause is key as it will define the following: -

- what constitutes force majeure (for which there is no specific legal definition).
- to what extent performance of the contract may be excused or suspended.
- what the procedure is to notify the other party if you are affected by force majeure.
- what the parties must do to mitigate or overcome the effects of the force majeure upon performance; and
- the consequences if satisfactory performance cannot be resumed.

Is Covid-19 a force majeure event? This will depend on the scope of the force majeure clause and whether the definition of force majeure includes, either expressly or by implication, matters such as pandemics, governmental action, or some other relevant trigger event. The drafting may be general or not exhaustive, so it is a question of interpreting the clause and what the parties intended when establishing the contract.

It is usual for force majeure clauses to set out expressly what the affected party, having established that the specific circumstances affecting performance fall within the definition of force majeure in the contract, needs to demonstrate in order to invoke the clause. This will depend on the drafting of the clause and could be:

- The party was **prevented** from fulfilling the obligations (most onerous to prove)
- The party was **hindered** in fulfilling the obligations
- The party was **delayed** in fulfilling the obligations (least onerous to prove)

With clauses including 'hindered' or 'prevented' the bar is set high to demonstrate that force majeure applies. For example, it is not enough to show that fulfilling the contract is economically unviable (i.e. reduction in customer demand) for the contract to be 'hindered' unless performing the contractual obligations would endanger the business or prevent it from entering into contracts with other parties.

Parties invoking force majeure will also need to demonstrate they have taken all reasonable steps to avoid or mitigate against the impacts of Covid-19.

Any process of cost recovery should be covered in the force majeure clause. However, if the clause is silent on this the assumption is that 'costs fall where they lie' (i.e. if costs have been incurred or payments the party affected cannot recover these). This may advantage one party more than the other however recovery may be possible and is discussed below.

Clearly it makes sense for the parties to be in discussions around how they deal with the contract and understand what solutions are available. Taking advice on this is key.

Material Adverse Change

Less common than force majeure clauses, and more likely to be found in complex or high-value contracts, Material Adverse Change clauses cover the effects of events or circumstances unforeseen at the time when the contract was made, such as a significant change in law or economic circumstance.

Given that the government has rapidly brought out new legislation as a response to Covid-19 and the economic circumstances have changed significantly, this clause may apply.

If this clause applies the parties may be able to vary, renegotiate or terminate their contract – depending on the wording of the clause.

Frustration

Unlike force majeure, frustration is enshrined in common law so has the potential to apply in every contract.

A frustrated contract is one where, as a result of some event or circumstance which has occurred or arisen after the contract was entered into and is not the fault of either party, it becomes impossible to perform the obligations or that they have now changed so radically from what was intended that it would be unfair to hold the parties to these obligations.

The effect of a frustrated contract is that the obligations of all parties come to an end immediately and neither party is liable for damages for non-performance. Unlike force majeure, if a contract is frustrated then costs incurred may in certain circumstances be recovered.

There is a high bar to demonstrate that a contract has been frustrated – similar to the 'prevented' requirement in a force majeure clause. Again, proving that it is more difficult or expensive to fulfil the obligations is not sufficient.

Whether Covid-19 would qualify as a frustrating event will depend on the circumstances for each contract, and in particular the specific effect of the Covid-19 outbreak on the ability of the parties to perform the contract.

Termination, Refunds & Insurance

For contracts that have been impacted by Covid-19 and where recovery may be pursued it is good practice to document both the sums paid / received under the contract and the products / services delivered.

- Termination - If one party to a contract is unable to fulfil the obligations in a contract this may be grounds for the innocent party to terminate the contract. The innocent party may then be entitled to claim damages for breach of contract to cover any losses sustained.
- Refunds – This will be dependent on the wording of the contract. In the case of a force majeure clause, the recovery mechanism should be included in the wording otherwise 'costs fall as they lie'. In contracts that are frustrated cost recovery is possible. Insurance (below) is an option where a party is left out of pocket for a terminated contract.
- Insurance – Business interruption insurance may cover a party for costs incurred which can't be recovered. There is no standard treatment of pandemics and force majeure clauses in insurance contracts, so it is important to check the wording of each contract in detail.

Landlords and Tenants

The rental contract for an office or factory premise is likely to be a material contract for most businesses. There are certain considerations which a business owner should consider when deciding how to deal with this contract.

What to consider

In the first case tenants should consider if there is a force majeure clause in the contract which may release them from obligations – however these are rare in commercial leases.

Suspension of rent in commercial leases are typically only if the premises is damaged, destroyed, or unusable due to an insured risk. Covid-19 does not appear to be covered by this so the contract would not allow the tenant to cease payments unless specific wording (e.g. covering pandemics, government closures etc.) are included.

Leases may contain certain other clauses which impact tenants and may be relevant in these circumstances, a “keep open” clause gives the landlord the right to damages if the premises closes, however, closures required by law should be exempt from this.

Options available

The Government announced a moratorium on 25 March 2020 which protects commercial tenants from some of the actions that landlords can take. The key point of this is that tenants cannot be forced to leave their premises until the moratorium ends – which is currently 30 June 2020. This also applies to any action which was in progress as at 25 March 2020.

However, this measure does not release the tenant from owing the rent and landlords are still able to take action for non-payment including calling on guarantors, demands to wind up the business and bankrupt individuals.

Therefore, it is recommended that the tenant and landlord communicate early and try to find a solution which works for both parties. Examples which we have seen so far have included deferrals, rent reductions, and rent cancellation.

Conclusions

Having open communication with the parties to a contract is important to reach an agreement on the best way forward. For business owners, contract law is typically not an area of expertise so taking advice is key.

Going forwards, businesses should consider the new contracts that are being entered into, what clauses should be included (e.g. force majeure, contingency measures, how liability is shared in the event of non-performance) and whether there is likely to be any further impact arising from Covid-19.

Insurance has also been shown to be key to businesses in this disruption so future policies should ensure all relevant risks are covered.