Commercial Contracts Governed By English Law: How To Get Out Of Your Obligations, Or Make Sure Your Opponent Keeps To Theirs!

The COVID-19 crisis has set in train a cascade of events that will impede, delay or prevent performance of many contracts in the coming months. Businesses are likely to face pressure from many directions: shortages of materials, shortages of staff, limitations on movement of personnel, restrictions on conducting operations, other legislative and administrative actions, and the insolvency of contractors, subcontractors and suppliers, to give only what is ultimately likely to be a limited set of examples. Through no fault of their own, many will find themselves in a position where it is impractical to perform some or all of their contractual obligations and where they will be forced to seek, by whatever means they can, temporary or permanent relief from performance.

I. Background

In general, four possible strategies are likely to be available:

- Renegotiate the terms of the contract, including by requesting waivers of contractual conditions and obligations.

- Invoke any force majeure clause in the contract and, depending on its terms, suspend or abandon further performance.

- Assert that the contract has been frustrated and, on that basis, abandon further performance altogether (and likewise release the counterparty from further performance).

- If legislative or administrative interference prevents the performance of specific terms, invoke the doctrine of severance to (in effect) delete the offending terms and preserve the rest of the contract.

In the case of merger and acquisition agreements and finance agreements, many of which contain material adverse change (or material adverse effect) clauses, such clauses may also provide a basis for drastic action in accordance with the contract, such as (for example) termination of a deal or the acceleration of loans.

Each strategy raises legal risks, which are addressed in detail below. However, some general observations may be made:

- Broadly speaking, the first option – if realistic in practice – carries the least legal risks (and often produces the best commercial outcome). However, parties seeking waivers or amendments should be aware of the need to ensure that any agreed changes can be evidenced if there is a subsequent dispute. They should also comply with any contractual conditions to amendments or waivers. Both should be (relatively) straightforward to achieve.

- The next two options, particularly relying upon the doctrine of frustration, are more drastic, and considerably riskier. The gravest risk they pose is that, by indicating a desire to limit the extent of its further performance, a party will inadvertently repudiate the contract. The financial consequences of this may be extreme. If the counterparty accepts the repudiation as discharging the contract, the default result is that the first party will be liable to put the counterparty in the position it would have been had the contract been performed (subject to the application of any relevant limitation or exclusion clause). The financial compensation which would then be payable could be very substantial.

- Asserting that specific terms of the contract have been severed from it offers a party an opportunity to preserve the deal but on potentially better terms. Severance operates to excise a clause (or part of a clause) from a contract where performance of the clause (or relevant part thereof) has become illegal. While it is difficult to establish all of the requisite elements of a severance claim, it may in certain circumstances offer a party a less risky means of escaping performance (or impossible performance) of an obligation as opposed to relying upon the doctrine of frustration or a force majeure clause.

- Where available, relying on a MAC clause may appear to be a safe ground for exiting an agreement which has been negatively impacted by the spread of the coronavirus. However, whether there has been an adverse change which is material is ultimately a subjective question, and, if it has to be determined by a court, will (in practical terms) be considered with the benefit of hindsight. Parties may therefore face uncertainty as to whether reliance upon a MAC clause will be upheld by a court.

Businesses may also find themselves in a position where they are reacting to actions taken by contractors. They may have to:

- Anticipate and respond to any decision by a counterparty to renegotiate the contract or seek to claim relief from performance.

- If the counterparty suspends or ceases performance, or indicates that it will be doing so, consider whether that amounts to repudiation of the contract, and (if so) elect whether to insist on performance or terminate the contract and claim damages.

The risks arising from repudiation fall overwhelmingly on the party seeking to exit a contract, so the possible occurrence of a repudiation could provide grounds for an opportunistic counterparty to initiate a renegotiation or settlement in its favour.

II. Varying or Amending Contracts

The impact of the spread of COVID-19 will inevitably result in some parties agreeing to amend their contracts, e.g. in terms of scope, dates for performance or potentially, both. A variation or amendment to an existing contract is itself a contract, and English common law generally imposes no *formal* requirements for the validity of a simple contract. English common law does impose certain *substantive* requirements, such as the rule that a promise must be supported by consideration in order

to be enforceable. As a result of the general absence of formal requirements in English law, parties have great flexibility and can easily enter into, or vary, contracts.

However, many contracts contain "No Oral Modification" clauses, which require variations to be agreed in writing. Recently, the UK Supreme Court held that such clauses are legally effective: *Rock Advertising Ltd v MWB Business Exchange Centres Ltd.*[1] Amendments that do not comply with the conditions imposed by such a clause are not effective.

In some circumstances, "No Oral Modification" clauses could lead to injustice. For example, what happens if an oral modification is agreed (despite such a clause) and a party performs the contract as modified? In English law, the safeguard against this sort of injustice is the doctrine of estoppel, which may prevent a party from relying on a No Oral Modification clause. However, in *Rock Advertising Ltd v MWB Business Exchange Centres Ltd*, the UK Supreme Court indicated that, in order to preclude reliance on such a clause, at the very least (i) there would have to be some words or conduct unequivocally representing that the variation was valid notwithstanding its informality; and (ii) something more would be required for this purpose over and above the informal promise itself. Accordingly, in practical terms, the doctrine of estoppel will often not be available to a party seeking to avoid the effect of a No Oral Modification clause.

Accordingly, while it may appear to be a trivial matter, compliance with all contractual conditions to amending a contract is essential.

If what is being sought is not an amendment to a contract but a waiver of a contractual requirement (e.g. that delivery by a particular date will not be insisted upon), the same principles apply. Many contracts contain provisions stating that a failure to exercise a right does not amount to a waiver of the right unless it is confirmed in writing (often referred to as a "No Waiver" provision). Such provisions are enforceable, and a party seeking a waiver should also ask its counterparty to confirm the waiver in writing. Parties which are asked to grant waivers but choose not to do so should also be aware that the courts have held that it is possible to waive reliance upon a No Waiver provision: *ZVI Construction Co LLC v The University of Notre Dame (USA) in England*.[2] This has the potential to hinder commercial discussions where a contractual obligation has not been met and a waiver is being considered. When is the party which has been asked to grant the waiver to be taken to have waived its reliance upon a No Waiver provision? Unfortunately, the cases offer little practical guidance on this point.

III. Force Majeure Clauses and Frustration – Different Responses to the Same Problem

The common law doctrine of frustration and "force majeure clauses" are different responses to the same question: when should a contracting party which, through no fault of its own, can no longer perform its obligations be relieved of the obligations or of liability for not performing them?

In general, parties to a contract are likely to be more satisfied by the answers given by their force majeure clauses than by the doctrine of frustration. The latter is an unwieldy, and unpredictable, instrument of the law. In general, and as detailed further below, it is exceptionally challenging to show that a frustrating event has occurred. Even if that hurdle is overcome, the effects of the application of

the doctrine of frustration are drastic. They are also rarely fair or commercially satisfactory to either party.

By contrast, force majeure clauses are likely to offer considered and commercially realistic solutions to the problem of impeded performance. They also generally set a lower threshold to the availability of relief. As to their effects, they tend, depending on their terms, to be more predictable and to achieve a more proportionate and sophisticated allocation of the losses resulting from the supervening event, which is in both parties' interests. Parties should therefore generally look to their force majeure clauses before considering invoking the doctrine of frustration.

IV. Force Majeure Clauses

Introduction

"Force majeure" (literally, "greater force") is not a term of art in English law, and it has no particular significance in common law systems.[3] Rather, it is a label used to describe exceptional events that commercial contracts commonly identify as entitling affected parties to escape liability for non-performance. The clauses specifying the relevant events and the required effect on the parties' obligations are known as "force majeure clauses".

As it is a creature of agreement and not of any overarching legal principle, the effect of a force majeure clause depends entirely on the terms in which it is drafted and the commercial background to and context of the contract in which it appears. However, drafting practices have converged over time, and most force majeure clauses require a similar set of conditions to be met before relief can be claimed. While each clause must be considered on its own terms, generally, such clauses require the party invoking them to prove four things:

- The occurrence of an exceptional event – the relevant "force majeure". The precise nature of the event can vary broadly. Relevant events are generally defined by their effect on performance rather than their nature. However, it is common to find a more prescriptive approach, in which (for instance) force majeure is limited to industrial action, military conflicts or natural disasters such as earthquakes.

- That the force majeure event has impeded a party's ability to perform to the necessary degree. The precise degree of interference required varies according to the wording of the clause. For instance, many contracts stipulate that the force majeure event must "prevent" performance,[4] whereas others require no more than "hindrance" or "delay".[5] Such distinctions matter in practice. An embargo of ports in a country affected by the coronavirus could, by way of example, affect a contractor's obligation to deliver materials very differently depending on which standard applies. If the relevant obligation is simply the delivery of materials and the applicable contractual regime requires prevention as a condition to relief, the contractor would be unlikely, on the face of the contract, to be able to claim force majeure as other methods of delivering the materials would be likely to be available. Instead, the contractor would generally be required to restructure its supply chain to source the materials from elsewhere (potentially at great costs).[6] By contrast, a force majeure clause subject only to a "hindrance" condition

might more readily enable a supplier to suspend its obligations entirely, avoiding major financial damage, in the same circumstances.

- A sufficiently close causal relationship between the force majeure event and the impediment to performance. An unexpected event is not sufficient – the force majeure event must impede performance. Surprisingly, this is often overlooked in the drafting of force majeure notices and reliance upon force majeure clauses. The necessary causal proximity between the force majeure event and the impeded performance will vary according to the terms of the force majeure clause. An affected party may have to prove that the event of force majeure is the operative cause of the impediment. Alternatively, it may be enough for the event merely to have contributed substantially to the occurrence of the event, such that while it is among the *concurrent* causes, the non-performance might have occurred without it. Commentators have traditionally considered the latter to be the default position in the absence of words to the contrary,[7] but recent case law casts doubt on this.[8] While the question remains open, and its answer will in each case (as ever) depend on the detail of the clause, it would be consistent with the judicial tendencies to interpret force majeure clauses restrictively for a party seeking to rely upon force majeure to be required to demonstrate that it would have been willing and able to perform the contract "but for" the force majeure event. This is a high standard. Bearing in mind that these matters will be judged with hindsight, parties seeking to rely upon force majeure provisions should consider keeping detailed contemporaneous records of steps taken to investigate and consider alternative means of performance.

  That the occurrence of the event and its effect on performance were beyond the party's control.[9] This generally means that the event must have been unforeseeable and beyond the control of the party seeking to claim force majeure (at the time of the event).[10] As to the former, if the event was sufficiently predictable to enable a sensible contractor to take precautions at the time of agreement, that will generally prevent the clause from operating. As to the latter, if the affected party can reasonably be expected to take sufficient measures to preserve its ability to perform notwithstanding the event, it will not usually be permitted to rely on the force majeure clause.

The English courts traditionally interpret force majeure clauses restrictively,[11] and the burden of proof is on the party seeking to rely on the clause.[12] While these conventions may come under pressure as the coronavirus cases play out in the courts,[13] engaging a force majeure always requires particularly careful factual investigation and contractual analysis. It is not to be done lightly, particularly as the consequence of an invalid reliance upon a force majeure clause may amount to a repudiation of the agreement.

Where a particular event is clearly within the scope of a force majeure clause, its terms are likely to exclude any frustration claim (discussed in the next section of this alert).[14] Thus, the broader and more general the definition of "force majeure event", the more likely the clause is to govern the consequences of frustrating events exclusively (although, as noted, courts seek to construe force majeure clauses narrowly).

A suggested checklist for evaluating the applicability of a force majeure clause

- Focus on the wording of the clause. Avoid the trap of assuming that extraordinary circumstances and extraordinary financial hardship are enough to amount to force majeure without more. In every case, the question depends on close and careful analysis of the terms of the provision, drawing where relevant on guidance in case law (but bearing in mind that the circumstances of every contract, and every case, will be different).

- Consider whether an event of force majeure has occurred. Again, this starts with the definition of force majeure. How broad is it? Does it require the occurrence of a specified event from a list, or is the definition more general (as in the standard forms)? Also, remember that "unlikely" is not the same as "unexpected" or "could not reasonably have been anticipated".

- Establish the exact cause of the impediment to performance. It may be tempting to think of every element of the response to the pandemic of governments, companies, and other organisations as facets of the pandemic itself, but that assumption is liable to produce a flawed analysis. What, exactly, causes the impediment to performance? Is it government quarantine measures that render performance illegal? Is it the knock-on effect of a border closure? Is it employees' unavailability to work on site? Which of these events is the sole operative cause, if it is possible to identify one? Once the causative event has been established, ask: does that event qualify as force majeure as defined in the clause, and why?

- Does the event impede performance to the necessary degree? Does the contract require prevention, hindrance, or delay to performance for relief to become available and if so, is that test satisfied?

- Consider what the parties could reasonably have done to plan for or mitigate the event at the time of contracting. Was the event foreseeable at the time of contracting, and could something have been done to avert its effects? Consider seeking subject matter expert advice.

- Consider alternative means of performance. If the impediment arises from the unavailability of workers in a particular area, is it possible to recruit from a nearby region? If there is any chance that it is possible, attempting the alternative performance is advisable. The existence of alternative means of performance would tend to suggest that there has not been sufficient impediment to performance enlivening a force majeure clause.

- Prepare evidence. The burden of proof is on the party seeking relief. Contemporary records regarding when the event arose, when it and/or its effects were identified, what steps were taken to minimize its effects, etc. should be kept.

- Give notice. Force majeure clauses are effective only on their terms and are strictly construed. Notice provisions must therefore be complied with scrupulously, with particular attention paid to time limits, which are generally enforced by English courts.

V. Supervening Illegality, Frustration, and Severance

The most direct and immediate threat to many commercial contracts posed by the coronavirus is simple: as government lockdowns grow in number and scale, performance may become illegal. While the measures prohibiting performance will almost always be temporary, they will mostly be of open-ended duration, and may last for some months.

The affected contracts may well be "frustrated" and come to an end. However, the doctrine of frustration is not the law's only response to supervening illegality.

English courts seek to apply the principle, sometimes referred to as "sanctity of contract"[15], that contracts must be adhered to. This generally requires parties either to perform their obligations or render their financial equivalent in damages. It is only in the most extraordinary circumstances that exceptions are made to this rule.

Reflecting this concern, where performance of a contract becomes partially illegal, the courts often try to save it. They use the following tools to do so:

- The doctrine of *severance*. Severance is the contractual equivalent of surgery, cutting the specific terms that are tainted by the illegality from the agreement so that the others can continue in effect.

- By looking to *the terms of the contract itself*. Where the parties have given some indication as to what the consequences of supervening illegality should be (and those consequences are not themselves illegal), a court will not generally usurp that allocation of risk. Force majeure clauses, many of which provide for the consequences of supervening illegality, are the classic case of such risk allocation.

However, in some cases, the contract is beyond saving. Performance may have become wholly illegal. Alternatively, the illegal part may be too fundamental to the parties' bargain for the contract to continue in anything other than a radically different form to that originally contemplated.[16] In these cases, frustration – specifically, frustration for illegality – intervenes to bring the agreement to an end.

Frustration applies in other cases where performance becomes impossible. Our primary focus in this update is on frustration for illegality, which is perhaps the most likely cause of frustration arising from the coronavirus crisis, although we also briefly address impossibility below.

In practice, parties should note that severance (on the one hand) and force majeure / frustration (on the other) are different points on the same spectrum. The broader the impact of governmental interference on a contract as a whole, the more likely the latter are to apply. Where legislative action is relatively limited in its impacts, it is more likely that the affected terms may be severed from the contract. Each possibility should be considered in any situation in which the legal and administrative response to the coronavirus affects contractual performance.

VI. Frustration

The doctrine generally

The doctrine of frustration operates to discharge a contract when something occurs after the formation of the contract which renders it physically or commercially impossible to fulfil, or transforms the obligation to perform into a radically different obligation from that undertaken at the moment of entry into the contract.[17]

This apparently straightforward summary belies the exceptional difficulties facing a party seeking to prove that a contract has been frustrated. In general, performance must be genuinely impossible. For instance, it might be that a law has been passed making it wholly illegal to deliver the contracted-for works, or the physical goods to be sold or hired might have been destroyed (and even then, unless the goods are unique, the law generally expects the seller to try to find and acquire sufficiently similar goods to meet its obligations). It is not enough that performance would merely inflict extreme, even ruinous, hardship on the performing party. If there is a manner of performing the contract which approaches the manner originally contemplated by the parties, that must be done, irrespective of the burden.

The courts are vigilant to keep the doctrine within tight bounds, ruling that it "*must not be lightly invoked and must be kept within very narrow limits*"[18] and "*ought not to be extended*".[19] This strictness reflects the principle. The courts' reluctance to find in favour of a party relying upon frustration also reflects an awareness that it is a blunt instrument whose results are often drastic, unpredictable, and unfair. Frustration operates to "*kill the contract*".[20] All of the parties are discharged from further performance of all of their obligations.[21] However, the losses that inevitably result do not always lie where they fall.

The Law Reform (Frustrated Contracts) Act 1943 provides as follows:

- Any sums paid before the frustrating event are to be repaid.[22]
- Money due before the frustrating event, but not in fact paid, ceases to be payable.[23]
- The court has a discretion:
    - to permit a party that has incurred expenses to deduct the value of the expenses out of any sums they were paid by the other party before the frustrating event;[24]
    - if a sum was due to a party at the time of the frustrating event, to permit that party to claim its expenses from that sum;[25] and/or
    - to require a party which received valuable benefit pursuant to the contract before the occurrence of the frustrating to pay a "just" sum.[26]

As is clear from this summary, these provisions are dependent on the exercise of a discretion by a judge, who is necessarily relatively remote from the commercial reality of the contract and relationship. Their operation is therefore unpredictable.

Frustration for illegality

As the coronavirus crisis develops, the doctrine of frustration is likely to play a particularly important role in unwinding contracts whose performance has become illegal. The case law addressing situations of this nature is highly developed, due in part to the frequency with which wartime measures

(such as, for instance, embargoes on trade with Europe[27] and domestic restrictions and requisitioning[28]) interfered with the performance of English-law governed contracts during the 20th century.

- The primary difficulty posed in cases of frustration for illegality is whether the illegality interferes enough with the bargain to warrant the discharge of the contract as a whole. This depends on whether the supervening prohibition affects the "main purpose" of the contract.[29]

- It can be difficult to judge what the main purpose of a contract is (or what a judge might regard it to be). That is particularly so in complex commercial arrangements. Such arrangements tend to have many components, each of which may be a substantial and important piece of work in its own right, but the components may be interrelated.

- As a general rule, the "main purpose" of the contract is often counterintuitively narrow. Courts may find a contract's main purpose to be capable of fulfilment even when the majority of what might be regarded as the commercially important elements or objectives of the bargain can no longer legally be delivered. This may be illustrated by reference to the 2010 case of *Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association Ltd*.[30] A shipping company took out broad ranging insurance, addressing a wide variety of events and risks, with an insurer. The United Kingdom government subsequently added the defendant to a blacklist of organisations suspected of involvement in terrorism. That rendered almost all of the insurance coverage under the policy illegal, but another decree exempted the parts of the policy that provided coverage in respect of certain oil spills. Performance of the contract thus became largely illegal but partly lawful. The court enforced the contract, finding that it was not frustrated. Its main purpose, the judge found, "*was to provide indemnity insurance*" and "*although the scope of cover is significantly narrower than it was before [the blacklisting] ... its nature is not different. It remains indemnity insurance*".[31]

- A contract will generally survive where a "non-trivial" part of the contracted performance can still be rendered. In the leading case, *Leiston Gas Co v Leiston-cum-Sizewell UDC*,[32] a gas company was contracted to install, maintain, and (every night for five years) light street lamps. Following the outbreak of World War I, a black-out was ordered, making it illegal to light lamps at night. Despite the fact that the intended ultimate outcome, gas-lit streets, became impossible for the indefinite future, the contract was not frustrated. The reason for this was that a part of the performance that could "*not be regarded as trivial*" remained lawful.[33]

- Notably, frustration for illegality can occur even where the illegality is merely temporary. For instance, in the World War II case of *Denny Mott & Dickson Ltd v James B Fraser & Co Ltd* ,[34] the illegality arose from regulations which would not last beyond the end of the war. It was enough that the interruption was long enough to destroy the essential identity of the works. Knowing exactly when that line has been crossed is very difficult. However, frustration for illegality is more generous in this regard than the general doctrine, which requires "*abnormal*" delay as a condition to relief.[35]

Illegality in cross-border contracts

Cross-border contracts are likely to be particularly disrupted in the next few months as national governments around the world grapple with epidemics of varying speed, scale, and lethality. Contractors may well find themselves in the (unenviable) scenario in which their English law contract requires them to do something that breaches foreign but not English law (or vice versa).

Reflecting its internationalism, English law accommodates this possibility. Whether an affected contractor can escape the contract on the grounds of illegality will depend on whether the performance is illegal in the *place where it was due to be rendered*. If so, the contract may be frustrated. If not, a frustration argument based on illegality will fail. In a recent example of how this doctrine works in practice, a European Union agency's lease in London was held not to be frustrated by Brexit, despite the agency's claim that its organizing statutes required it to be based in an EU member state. What mattered was that the obligation could be performed under the laws of the place where the building was located.[36]

The process of determining the law of the place of performance can be complex, but that is beyond the scope of this update. We will be pleased to provide specific advice in that regard.

Frustration for impossibility

The doctrine of frustration may also play an important role in unwinding contracts whose performance has become impossible (as opposed to illegal) as a result of the pandemic, due to, for instance, (i) illness or death of the performing party; and/or (ii) shortages of raw materials, staff, transport providers, storage facilities etc. necessary to perform the contract.

We are not aware of any English cases in which a pandemic was grounds for frustration of a contract. Accordingly, it is perhaps most helpful for this purpose to consider some of the instances in which the English courts have historically accepted that a contract has been frustrated for impossibility:

- **Destruction of underlying subject matter:** In the case of *Taylor v, Caldwell,*[37] a music hall hired from a defendant was destroyed in an accidental fire, such that it became impossible to stage the concerts envisaged under the contract. Although the claimant argued that the defendant was in breach of contract in failing to supply the hall, the court held that the contract had been discharged, as the destruction of the music hall rendered performance impossible.

- **(Temporary or permanent) unavailability of the subject matter:** In the case of *Bank Line Ltd v Arthur Capel & Co Ltd*[38], a charter contract was held to have been frustrated due to the fact that the ship had been requisitioned and was therefore no longer available to the charterer. Frustration may also occur in instances where the subject matter of the contract is temporarily unavailable (e.g. due to a ship being grounded for repair), in which cases the courts consider the ratio of the likely interruption of the contractual performance to the duration of the contract as a whole.[39] The higher the ratio, the more likely it is that the contract has been frustrated. However, the delay must be so abnormal that it falls outside what the parties could have contemplated at the time of the contract.[40]

- **Death or grave illness:** The English courts have found that contracts for personal services, such as contracts of employment, are frustrated by the death of either party to the contract, or if an employee falls so ill as to be permanently unfit to work.[41]

In certain limited instances, the courts have also accepted the frustration of a contract on the basis that the "common purpose" for which the contract was entered into can no longer be carried out because of a supervening event (as opposed to the performance itself becoming impossible or illegal). The case of *Krell v Henry* is a rare example of such a case, where the defendant hired a flat from the claimant for two days for the purpose of viewing the coronation of Edward VII. When the King fell ill (and the coronation was postponed), the claimant sought to enforce the terms of the contract. The Court of Appeal held that the contract had been frustrated.

Krell v Henry was, however, a very narrow decision, and it must be emphasised that the courts do not wish to grant a party an 'easy out' in the event that the contract has simply become a bad bargain for it. The case of *Herne Bay* is significant in this context, as Vaughan Williams LJ did not accept that the contract had been frustrated and stated that: "*I see nothing that makes this contract differ from a case where, for instance, a person has engaged a [vehicle] o take himself and a party to Epsom to see the races there, but for some reason or other, such as the spread of an infectious disease, the races are postponed. In such a case it could not be said that he could be relieved of his bargain.*" In the current context, therefore, the courts will need to consider the 'bargain' that has been struck between the parties, by looking at the: (i) express terms of the contract; and (ii) the allocation of (express and implied) risk within that contract.

Interaction with force majeure clauses (and other contractual allocations of risk)

Force majeure clauses have the incidental effect of shutting out arguments that an event within the clause's scope has frustrated the contract. In the eyes of an English court, parties who agree to a force majeure clause have – almost by definition – considered the circumstances in which supervening events should entitle them to cease performance. As such, they may be taken to have established a contractual code covering, or at least heavily encroaching on, the same ground as the common law doctrine. If they have thus (effectively) "contracted out" of frustration by (for example) including a force majeure clause in their contract or otherwise providing for a contractual obligation or remedy inconsistent with frustration, the courts will have no hesitation in permitting them to do so. Faced with a choice between giving effect to the parties' (albeit presumed) intentions and the blunt instrument of frustration, courts can be expected to choose the former. Freedom of contract trumps the policies underpinning the doctrine of frustration.

The presence of a force majeure clause is not, however, necessarily fatal to a frustration argument. As explained above, the courts generally interpret such clauses restrictively. One of the consequences of this is that words which would be wide enough to capture a particular supervening event if taken literally may, on their true (strict) construction, leave room for the doctrine of frustration to operate.[42]

VII. Severance

Where performance of a contract is only *partially* illegal, English law may allow the objectionable term to be severed from the rest of the contract, with the result that the remainder of a contract is enforceable.

Severance can be thought of as the obverse of frustration for illegality. If a contract whose performance has become partially illegal is not frustrated for illegality, the part of performance that is illegal is severed from the agreement. Within that framework, it is often said that there are three requirements for severance to operate:

1. The "blue-pencil" test: can the unenforceable provision be removed without the necessity of adding or modifying the wording of what remains?

2. Adequacy of consideration of remaining terms: are the remaining terms supported by adequate consideration (i.e. was at least part of the contract price, or whatever was to be given in return for performance, paid/given in return for performance of such terms)?

3. Impact of removal of unenforceable provision on character of contract: does the removal of the unenforceable provision change the character of the contract so that it becomes "*not the sort of contract that the parties entered into at all*" (to use the words of one of the cases)?[43]

Although these general requirements will determine whether a particular term is severable, businesses will need to be aware that each case (and each contract) will need to be analysed carefully to achieve the correct result.

VIII. Repudiation

The perils of repudiation loom large over any party considering claiming frustration or force majeure. It is likely frequently to come into play in the coming months and years as contractors struggle to perform their contractual obligations.

Repudiation is the common law doctrine that provides for the consequences of a party's refusal to deliver the contracted-for performance. Following such a refusal, the innocent party has the choice either to demand performance (thereby "affirming" the contract) or to accept that the contract is at an end and claim its lost value (thereby "accepting" the repudiatory breach).

Repudiation can occur in two ways. First, a party may fail to perform its contractual obligations when due. Alternatively, a party may indicate by words or conduct that it does not intend to be bound by an obligation that has yet to fall due for performance (often referred to as "anticipatory repudiatory breach"). This may arise inadvertently, including when a party is, in good faith, seeking to exercise a right which it believes it has but does not. For example, a notice stating that it will be impossible to carry out certain contractual obligations due to force majeure is a statement by the party issuing the notice that it does not intend to carry out the obligations in question. If the grounds for the force majeure claim are not made out, service of the notice may have amounted to an anticipatory repudiatory breach of the contract.

To amount to repudiation, the failure to perform must affect a fundamental element of the bargain, such as (for example) the obligation to pay the contract price. The test for the requisite breach

is often described as requiring a refusal to perform an obligation that goes to the "root" or "essence" of the contract. The test is highly fact-sensitive, and whether it is met depends on the construction of the contract and the circumstances of the case. For example, where the time of performance of a particular contractual obligation is stipulated to be of the essence, failure to perform by the time specified will be a repudiatory breach.[44] However, where time is not specified to be of the essence, delay in and of itself will rarely amount to a repudiatory breach (although it if coupled with other factors, such as a deliberate reduction in manpower).

Faced with a repudiatory breach, the innocent party may either "accept" or "affirm" the contract.

- In the first scenario, the contract ends. Both parties are discharged from further performance. Subject to the requirement to mitigate its loss, the innocent party also generally acquires a valuable damages claim, although it will have lost the expected performance of its counterparty and that counterparty may not be 'good for the loss'.

- Alternatively, the innocent party may insist on performance (and it may also claim damages for the loss caused by the breach, although the quantum of such damages would likely be less than the damages payable if it accepted the repudiation). In practice, affirming the contract is a viable strategy where there is still a measure of trust and goodwill between the parties and/or if an alternative contractor cannot be found to achieve the original objectives of the contract in the present circumstances. In the course of the present crisis, affirmation may be the logical step in many cases.

Repudiation is likely to be the consequence where a party can no longer perform and is unable to invoke frustration or force majeure. It may also prove to be a consequence of the intermittent disruption to the performance of contracts that is likely as the coronavirus crisis unfolds. In particular, English law recognises a form of repudiation that may be termed "repudiatory creep" (or, more formally, "cardinal change"): a situation in which a party does not repudiate the contract all at once but incrementally over time.[45] In this scenario, the party at fault gradually varies the manner of its performance until it is no longer doing what was originally promised.

It is easy to envisage scenarios in which the various pressures caused by the coronavirus will impel a contractor to vary the scope of work, use different products or goods to those originally contemplated, or delay completion (for example). A counterparty faced with such conduct can consider asserting a repudiatory breach. While the factual investigation in such a scenario is different to that in a more conventional case, the legal analysis is, in substance, the same. The counterparty should:

- identify the scope of the performance that was promised by reference to the facts at the time of contracting; and

- establish what has in fact been (or will be) delivered.

If there is a fundamental difference between the two, it may be possible to allege a repudiation. Such an allegation may be deployed in various ways and to various ends.

- The innocent party – typically the employer – may make the allegation and reserve its rights to accept the repudiation or affirm the contract while it investigates the situation. This can, in the right conditions, set the scene for a negotiation in which the innocent party may obtain practical improvements to performance that are sufficient to justify continuing with the contract. However, a termination right is (in practical terms) a "use it or lose it" right. A right to repudiate could not be reserved indefinitely.

- Alternatively, the innocent party may simply inform the counterparty of its position and state that it will treat the contract as discharged. This may be advantageous where, for instance, the former wishes to replace the latter. However, any party taking the step of accepting a counterparty's (purported) repudiation and treating the contract as discharged must take great care to assess the strength of its position in doing so: if the counterparty is subsequently held not in fact to have repudiated the contract (e.g. because its breach is found not to have been sufficiently material to go to the root of the contract), the 'innocent' party which took the decision to accept the purported repudiation risks being held to have repudiated the contract itself, with all the adverse consequence that entails.

IX. Material Adverse Change / Effect

Finance Agreements

In finance documents, a "material adverse change" generally arises where there is significant deterioration in the financial condition of the borrower that falls short of insolvency but nonetheless gives rise to a substantial risk of non-payment. The concept generally plays two roles:

- A material adverse change often qualifies as an event of default. By calling an event of default, a lender can accelerate the outstanding loan, withhold any further advances, and generally be relieved of its obligations under the finance documents.

- In addition, it is common for borrowers to be required to represent that there has been no material adverse change at specified times (commonly as a condition precedent to each drawdown).

Historically, these "material adverse change clauses" ("**MAC clauses**"), whether structured as events of default or repeating representations, have rarely been invoked in English-law governed finance documents. The primary reasons for this are that:

- Invoking a MAC clause carries serious risk. The consequences are particularly grave if the lender relies on the occurrence of an alleged material adverse change to refuse to provide further advances. In that scenario, if there has not been a change coming within the scope of the clause, the lender will have committed a serious breach of contract, most likely amounting to a repudiatory breach. It would thereby become liable to pay the borrower the damages necessary to put it in the position it would have been in had the advance been made. Such damages can be very substantial.

- Establishing whether or not there has been a material adverse change is difficult. It is a concept of uncertain scope, occupying the hinterland between full-blown insolvency (usually provided as an event of default in its own right) and reasonable financial health. Reflecting this conceptual uncertainty, MAC clauses are often drafted in vague or imprecise terms. In practice, it is difficult both to identify what material adverse change is and to prove that it has happened.

The effects of the coronavirus on borrowers' finances may be sufficiently drastic to tempt many lenders to resort to this little-used event of default. It is perhaps more likely that most distressed situations arising from the coronavirus pandemic will be dealt with using other, clearer-cut contractual remedies (as was the case in the wake of the 2008/09 financial crisis). However, it is inevitable in a time of such unprecedented crisis that certain lenders will feel impelled to invoke this clause.

Material adverse change clauses

The concept of material adverse change varies, in large part because MAC clauses are usually heavily negotiated.

In the context of events of default, the definition is generally very broad. That is probably because such MAC clauses are intended to operate as a safety net, coming into play only where other, more precisely defined events of default are not available.

Where the agreement also contains a MAC clause that is structured as a repeating representation, the required "change" is sometimes (but not always) defined more narrowly. Often, such MAC clauses will specify that the change must be to the borrower's business or financial condition. However, broader definitions are not unusual, and sometimes drafters borrow the concept as it applies in the context of events of default and put it into service in the repeating representations.

The English case law

There have been only a small number of reported judgments from English courts examining the interpretation of MAC clauses. Perhaps the most useful guidance is to be found in *Grupo Hotelero Urvasco SA v Carey Value Added SL & Anor*, which arose in aftermath of the 2008/09 financial crisis.[46] The particular MAC clause in question required the borrower to represent that there had been no material adverse change in its own financial condition (consolidated if applicable) or that of the other obligors since a particular date. If it failed to do so (or gave an untrue representation), the lender became entitled to withhold further advances. The court found for the lender, ruling that:

- There was a distinction between MAC clauses requiring the change to affect the "financial condition" of the borrower (as in the facilities agreement at issue) and those in which the change could be to its "business condition" (as in other documents in the suite which were not directly at issue). The first of these variants was narrower. The judge considered the latter to be broader.[47]

- "*To be material, the adverse change must be material in a substantial way to the borrower's ability to perform the transaction in question*".[48] The mere occurrence, for instance, of an event making it difficult or impossible for the borrower to borrow further sums would not be enough if the borrower remained able to perform its duties under its agreement with the lender.

- The lender cannot, in the absence of express words to this effect, trigger the clause on the basis of circumstances of which it was aware at the date of the contract. It will be assumed that the parties intended to enter into the agreement in spite of those conditions, although it will be possible to invoke the clause where conditions worsen in a way that makes them materially different in nature.[49]

- Finally, in order to be material, any change must be more than merely temporary.[50]

In addition to these observations, the Court commented on the proper approach to the evidence, at least in cases where the material adverse change required is to the company's financial (as opposed to business) condition. Mr. Justice Blair found that the best evidence of a company's financial information would generally be its formal accounts and other financial documents (as opposed, for example, to macro-economic conditions or its conduct or public statements).[51] Those materials are not, however, the only relevant evidence, and "*[t]here may be compelling evidence to show that an adverse change sufficient to satisfy a MAC clause has occurred, even if an analysis limited to the company's financial information might suggest otherwise*". For instance, a failure to pay other bank debts would be "*highly relevant to the question whether a material adverse change has occurred*".[52]

The extent to which these findings can be generalised into rules of thumb for other MAC clauses is unclear. They are expressed in broad terms that are relevant, on their face, to the interpretation of most MAC clauses. However, the case was decided on the particular wording of the MAC clause at issue and on its own facts. Other MAC clauses may operate differently in practice.

COVID-19

The extent to which lenders will invoke their MAC clauses in the face of the coronavirus pandemic is difficult to predict, and lenders would be wise to be cautious, at least in the immediate term:

- It is unclear how long the various quarantine and social distancing measures will be in play. That is significant: a material adverse change must generally be permanent, not temporary. The scope for lenders to rely on MAC clauses thus depends, to some extent, on how long government lockdowns last in the relevant jurisdictions.

- The pandemic has had calamitous effects on global stock and financial markets. However, it would be unwise to suppose that the mere fact that the financial system is in meltdown, dramatic as that is, amounts to a material adverse change in the borrower's financial or business condition. Even the most disastrous macro-economic events are unlikely to be material adverse changes in and of themselves. Unless and until their effects manifest themselves in the borrower's financial position (or even, potentially, its financial documents), any MAC clauses are unlikely to be engaged.

- The final, and perhaps most important, source of uncertainty arises from the measures adopted by Western governments to shore up the financial system and real economy. Those measures are of unprecedented scale and depth, but no-one is yet sure how effective they will

be. The most important factor in lenders' ability to rely on their MAC clauses may prove to be whether, and to what extent, governments and central banks are able to contain the economic damage.

Acquisition Agreements

Many merger and acquisition and similar agreements contain a material adverse change or material adverse effect clause or condition ("MAC" or "MAE") that allows a buyer to terminate the agreement in the event of a material adverse event affecting the target's business, financial position, profits or prospects. English courts have held that such clauses are enforceable[53] but there is otherwise little case law in England providing guidance as to when they can be invoked.

The entity seeking to rely upon a MAC clause will bear the burden of establishing that all of the conditions to the clause have been satisfied. Contemporaneous documentary evidence from the period leading up to the execution of the relevant agreement may be key to establishing whether the nature and extent of the adverse change relied upon is genuinely material to the party seeking to exit an agreement.

Ultimately, it may be premature to tell how long-lasting the effects of the COVID-19 epidemic will be. But if corporate earnings are depressed and analysts predict potential longer-term effects for certain companies and industries, MAC clauses may become relevant.

X. Indirect Impacts on Contractual Performance

Finally, businesses should consider the risks associated with requiring part or all of their operations to continue in the current circumstances and their potential liability to individuals in tort. While the duty of care owed under English common law is not unlimited, a business which requires its operations to proceed, or requires contractors to continue to perform their services, may, in extreme circumstances, be argued to be in breach of a duty of care to its staff or the staff of contractors, and possibly even the public at large, if its actions expose individuals to a greater risk of being affected by coronavirus or contribute to the spread of the disease.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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[1] [2018] UKSC 24.
[2] [2016] EWHC 1924 (TCC).
[3] The term originates in the French Civil Code, which through various iterations has treated "force majeure" as a defence to a claim for damages for breach of contract.
[4] For an overview of such clauses, see Chitty on Contracts 33rd Ed. at 15-156-157.
[5] These provisions are briefly considered at 15-158 and 15-158 respectively of Chitty on Contracts 33rd Ed.
[6] However, the wider factual matrix concerning the contract might be relevant. For example, if it was self-evident to the parties, when they entered into the contract, that the materials in question would always need to be imported by ship, an argument that delivery has been prevented may be available.
[7] *Bremer Handelsgesell-schaft v Vanden Avenne* [1978] 2 Lloyd's Report 109; *Bremer Handelsgesellschaft v Westzucker* [1981] 2 Lloyd's Reports 130. See also Chitty on Contracts, 33rd Ed. 15-156. The level of causal proximity required may turn on whether the force majeure is drafted so as to operate as an exemption clause, relieving a party from the consequences of breach, or whether it prevents a breach from occurring in the first place (the approach adopted in many standard form construction contracts). Arguably, on the latter approach, there is no need to show that Force Majeure is the sole operative cause of prevention. As always, the position will ultimately depend on a detailed investigation of the specific terms of the clause and the commercial context in which it operates.
[8] *Classic Maritime Inc v Limbungan Makmur SDN BHD* [2019] EWCA Civ 1102.
[9] *Channel Island Ferries Ltd v Sealink (UK) Ltd* [1988] 1 Lloyd's Rep. 323, 327, 328; *Mamidoil-Jetoil Greek Petroleum Co SA v Okta Crude Oil Refinery AD (No.2)* [2003] EWCA Civ 1031.
[10] *Trade and Transport Inc v Iino Kaiun Kaisha Ltd* [1973] 1 W.L.R. 210, 224–227.
[11] *Channel Island Ferries Ltd v Sealink United Kingdom Ltd* [1988] 1 Lloyd's Rep. 323, *Tandrin Aviation Holdings Limited v Aero Toy Store LLC., Insured Aircraft Title Service, Inc.* [2010] EWHC 40 (Comm), 2010 WL 19913 at paragraph 43.
[12] *Channel Island Ferries Ltd v Sealink United Kingdom Ltd* [1988] 1 Lloyd's Rep. 323, 327.
[13] In particular, the courts have, some commentators argue, recently loosened a similar rule that was thought by many to apply to exclusion clauses (see *Transocean Drilling UK Ltd v Providence Resources Plc* [2016] EWCA Civ 372)). Since force majeure clauses are sometimes regarded as a species of exclusion clause, parties invoking them may seek to rely on that parallel development to contend that the courts should interpret them more liberally than the older cases suggest.
[14] See, e.g., *Larrinaga & Co v Société Franco-Américaine des Phosphates de Medulla* (1923) 92 L.J.K.B. 455 and *The Maira (No 2)* [1985] 1 Lloyd's Rep. 300.
[15] Or by reference the Latin maxim: "*pacta sunt servanda*". See generally *Frustration and Force Majeure* 3rd Ed. 2-037 to 2-038.
[16] Less pertinently for present purposes, if the illegality is very serious, public policy may require a more robust response than severance or the terms of the contract can provide.
[17] Chitty on Contracts, 33rd Ed. 23-001.
[18] *J Lauritzen AS v. Wijsmuller BV, The "Super Servant Two* 29 [1990] 1 Lloyd's LR 1 at 8.
[19] Ibid.
[20] *J Lauritzen AS v. Wijsmuller BV, The "Super Servant Two* 29 [1990] 1 Lloyd's LR 1 at 8.
[21] Except governing law, jurisdiction, and arbitration agreements.
[22] The Law Reform (Frustrated Contracts) Act 1943, s. 1(2)
[23] Ibid, s. 1(2).
[24] Ibid, s. 1(2).
[25] Ibid, s. 1(2).
[26] Ibid, s. 1(3).
[27] See e.g. *Fibros Spolka Akcyjna v Fairbairn Lawson Combe Barbour Ltd* [1943] AC 32, in which an English company agreed in 1939 to sell machinery to a Polish company and to deliver it to Gdynia, which became illegal when that port was occupied by the Germans later the same year.
[28] *Metropolitan Water Board v Dick, Kerr & Co Ltd.* [1918] A.C. 119; *Denny Mott & Dickson v James B Fraser & Co Ltd* [1944] A.C. 265.

[29] *Denny Mott & Dickson Ltd v James Fraser & Co Ltd* [1944] A.C. 265. p. 271.
[30] [2010] EWHC 2661 (Comm)
[31] Ibid at para 115.
[32] [1916] 2 K.B. 428.
[33] Ibid. at 433.
[34] [1944] A.C. 265. p. 271.
[35] *Blankley v Central Manchester And Manchester Children's University Hospitals NHS Trust* [2015] EWCA Civ 18.
[36] *Canary Wharf v European Medicines Agency* [2019] EWHC 335 (Ch).
[37] [1863] 3 B. & S. 826.
[38] [1919] AC 435
[39] See e.g. *Jackson v Union Marine Insurance Co Ltd* (1874) L.R. 10 C.P. 125
[40] *Pioneer Shipping Ltd v BTP Tioxide Ltd (The Nema*) [1982] AC 724
[41] See e.g. *Hall v wright* [1859] 120 E.R. 695.
[42] *Metropolitan Water Board v Dick Kerr & Co* [1918] A.C. 119; see also *Fibrosa Spolka Akcyjna v Fairbairn, Lawson, Combe Barbour Ltd* [1943] A.C. 32 and *Empresa Exportadora De Azucar v Industria Azucarera Nacional SA (The Playa Larga)* [1983] 2 Lloyd's Rep. 171.
[43] *Sadler v Imperial Life Assurance Company of Canada Ltd* [1988] IRLR 388 as quoted in *Beckett Investment Management Group Ltd v Hall* [2007] EWCA Civ 613.
[44] *Bunge Corpn v Tradax SA* [1981] 2 All ER 513.
[45] *Sanderson v Simtom* [2019] EWHC 442 (TCC). *See also C& S Associates UK Ltd v Enterprise Insurance Company Plc* [2015] EWHC 3757 (Comm), [2016] All ER (D) 19 (Jan).
[46] *[2013] EWHC 1039 (Comm) (26 April 2013).*
[47] Ibid, para 349.
[48] Ibid, para 356-357.
[49] Ibid, para 362.
[50] Ibid, para 363.
[51] Ibid, para 351.
[52] Ibid, para 352.
[53] *Kitcatt v MMS UK Holdings Ltd* [2017] EWHC 675 (Comm); [2017] 2 BCLC 352.