

COVID-19: Contractual Implications for Businesses and Investors

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The mysterious new virus first hit the headlines in late 2019, with several cases of viral pneumonia emerging in Wuhan, China. Less than three months later, the new coronavirus has infected over 116,000 people worldwide and caused more than 4,000 deaths. Economies and public health systems alike are showing signs of stress. Travel restrictions, event cancellations, and sick and self-isolating workforces are causing difficulties for businesses across the globe, many of which are now unable to perform contracts in the manner agreed with their contractual counterparties. In this note, we consider some of the English law contractual provisions which may be engaged by the coronavirus epidemic, including clauses on 'force majeure' and on material adverse changes.

Force Majeure and Frustration

Although 'force majeure' as an excuse for failed contractual performance has no automatic application in English law, a force majeure clause of some kind is included in most commercial English law contracts. Such a clause typically suspends or extinguishes a counterparty's obligation to perform the contract in specific, often so-called 'emergency', circumstances. Because the concept has no legal meaning outside that which is drafted in the contract, a huge amount will turn on the specific drafting of the clause. Answers to the following questions will depend on the specific drafting used:

- **In which 'emergency' or other circumstances does the clause apply?** Typically a force majeure clause applies in cases of natural disaster, epidemic, civil war, terrorist attacks, changes in the law or other government action, and similar designated circumstances. Unless these terms are further defined in the contract, they will have their ordinary meaning. In the case of coronavirus, it will be particularly significant to establish where and when the virus first constituted an epidemic.
- **Does the circumstance need to prevent performance or only make it more difficult?** Clauses may provide for remedies if a force majeure event 'prevents' contractual performance, or more widely for example 'prevents, hinders, or delays' performance. It will be a question of fact in each case whether the event 'prevented' or merely 'hindered' or 'delayed' performance.
- **Does the force majeure event need to be unforeseen?** Experts have previously warned about the possible emergence of a virus more or less like the new coronavirus. It may be arguable in some cases (especially for any contracts agreed since the beginning of 2020) that the coronavirus was foreseen or foreseeable by counterparties. Depending on the clause's drafting, this could prevent a party from relying on the clause to excuse their contractual performance.

In some cases where the coronavirus epidemic has prevented the performance of a contract, counterparties may claim that the contract has been frustrated instead of claiming that a force majeure clause applies. The principle of frustration in English law does not depend directly on the drafting of the contract, and applies when an unforeseen event renders the performance of a contract physically impossible, or transforms the obligation to perform into something radically different. For example, it is largely impossible at the current time to travel around Italy, due to the lockdown imposed by its government. This could physically prevent performance of many contracts.

If a contract has been frustrated, it is automatically discharged and the parties are released from any future obligations, and thus would not have to pay damages for non-performance. However, if the parties have made express provision in a contract for a particular event (for example, if they have allowed for it in a force majeure clause), the relevant contract will not be frustrated.

Material Adverse Change

Many commercial contracts, particularly in the finance and M&A spheres, may include provisions referring to a 'material adverse change' ("**MAC**"). Such a contract may require the borrower or seller (as applicable) to make a representation that, for example, no MAC has occurred since the company's most recent financial statements. It may also provide that the occurrence of a MAC constitutes an event of default, allowing the lender or buyer to terminate the contract in such a case. In recent times when participating in competitive auction processes for prized assets, bidders (particularly in European markets) have often been less successful in including MAC clauses in their purchase agreements. Deal certainty and timing is usually of critical importance for a seller in a competitive process and, often, even more important than a bidder's potential price. Coronavirus may now however have an impact on competitive deal documentation and the acceptance of MAC clauses even within auction processes. Conversely and depending on risk appetite and available resources, some investors may view the coming months as an opportunity to acquire assets at a potential discount.

The meaning of a MAC in any case will be determined by the wording of the relevant contract. Typically included are material changes to a company's business or prospects; to its ability to perform its obligations under the contract; and in finance agreements, to the validity or enforceability of a lender's security. There are clearly businesses (airlines and travel-related businesses arguably foremost among them) which have already been, and will continue to be, materially impacted by the coronavirus epidemic, whether by public concern, workforce issues, or travel restrictions or cancellations. As such, some MAC clauses could be triggered, meaning that financing arrangements for such businesses could be at risk of being withdrawn, or may have additional conditions attached to them, and/or some acquisitions may fail to go ahead as planned.

As well as a business-specific MAC, some contracts also provide for a 'market MAC' – a provision that deals with cases where there has been a material adverse change to the financial, banking, and/or capital markets. Although global financial markets have indisputably been affected by the virus, each specific case would turn on the facts and the drafting of the applicable 'market MAC' clause. For instance, the clause will typically govern which specific markets must be affected by the MAC, and whether there is a subjective or objective trigger for the occurrence of a MAC (i.e. whether the trigger is the objective occurrence of a MAC, or the lender's reasonable belief that one has occurred).

Steps To Take Now

If an investor or business is concerned that its own enterprise, or the business of a portfolio or group company, or any companies in its supply chain, has been affected by the coronavirus epidemic, it should review any affected contracts (or contracts that may potentially be affected) as soon as possible, with assistance from legal advisors where useful. Whether the business anticipates an impact on itself or on its counterparty, it should ensure it understands its contractual position as early as possible in order to take appropriate legal steps.

As the affected party, appropriate steps may include documenting the force majeure event (or even obtaining a 'force majeure certificate' where relevant), and notifying and/or entering negotiations with a counterparty. As the non-affected party, re-negotiations may also be advisable, but ultimately legal action against a non-performing counterparty may be required. Many businesses and investors will find themselves in the middle of contractual chains, in which failure to perform by a supplier will affect their own performance in a dependent contract. In such cases, businesses could quickly find themselves in multiple interlinked disputes, which need to be managed efficiently.

Finally, monitoring will be of utmost importance for all businesses and investors in the coming weeks and months. The progression of the virus is difficult to accurately predict. As such, it is imperative that the legal position is understood and clearly mapped out without delay.

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