COVID-19
Frustration, Force Majeure & Material Adverse Change

Governments across the world have taken unprecedented steps to restrict ordinary daily life in an effort to mitigate the severe impact of Covid-19. The human impact is enormous but the pandemic will also have profound short and long-term economic effects.

Andrew Spink QC and Saaman Pourghadiri, of Outer Temple Chambers, summarise how contractual obligations may be affected by the pandemic and the measures taken to quell it. This note will look at some key elements in construing FM clauses and the common law doctrine of frustration before considering MAC clauses.

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2. Speed Read

Force Majeure ("**FM**") clauses can excuse parties from contractual performance. The scope and effect of a FM clause is a matter of construction. FM clauses will usually specify the series of events which they cover. Typically:

- *performance must be rendered impossible by the event*
- *the event must have been beyond the control of the defaulting party*
- *the defaulting party must have taken all reasonable steps to avoid the event*
- *the event must be the only effective cause of default.*

Frustration is a common law doctrine. If an unforeseeable event occurs after a contract is formed, which radically changes the nature of the contract, then the contract may be frustrated. The effect of frustration is to discharge the parties from future performance, but the contract is not made void ab initio. Pursuant to the Law Reform (Frustrated Contracts) Act 1943, the court has the power to make adjustments to each party's position to reflect monies paid, expenses incurred and benefits received prior to the discharge of the contract.

Material Adverse Change ("**MAC**") clauses are typically found in M&A and finance documents. Typically, they permit a purchaser not to complete an acquisition in the event of a material adverse change, or they permit a lender to decline to advance any further lending or call an event of default. MAC clauses are infinitely varied and the circumstances in which they will be triggered are a matter of construction and careful evaluation of the change in question.

Whether Covid-19 and the global response to it fall within FM or MAC clauses or trigger the application of the doctrine of frustration will involve a close analysis of the facts to determine the precise impact of the pandemic on the business or performance of the contract in question coupled with a careful interpretation of the relevant terms of that contract.

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3. Force Majeure Clauses

FM clauses excuse the parties from performing all or part of their contractual obligations if specified events occur. They can have a range of effects, from suspending the parties' contractual obligations to affording them an option to terminate.

The scope and effect of a FM Clause will be determined by the court applying the ordinary principles of contractual construction. Similar language often appears in a wide range of force majeure clauses, so the decided cases can offer more focussed guidance.

FM clauses typically require performance to be *"prevented"*. This language requires performance to be impossible. It is insufficient that performance has become more difficult or more expensive (e.g. *Thames Valley Power Ltd v Total Gas & Power Ltd* [2005] EWHC 2208 (Comm)). In and of themselves, the present turmoil in the financial markets, cost of credit or similar economic factors will likely be insufficient to trigger a FM clause.

FM Clauses typically require the event to be *"beyond the control of"* the relevant party. This language requires the party to take reasonable steps to mitigate the effects of the force majeure (in *Tandrin Aviation v Aero Toy* [2010] EWHC 40 (Comm), a case concerning a failure to deliver an aircraft Hamblen J used the example of a *"pandemic causing a dearth of delivery pilots"*).

For example, one might expect a government mandated closure or an absence of employees due to sickness caused by a pandemic to be beyond the control of a given business. A more complex question arises where the business has not been literally prevented from performance but has *chosen* to take precautionary steps in response to Covid-19. Whether such a business can take advantage of an FM clause requires an acute focus on the FM clause in question and the severity of the circumstances that the business faced.

FM clauses typically specify that performance is excused *"if and to the extent that"* performance was prevented by the specified occurrences. Such language means that the FM event must be the *only effective cause* of the default (see e.g *Seadrill Ghana Operations Ltd v Tullow Ghana Ltd* [2018] EWHC 1640 (Comm)). For example, a particular FM clause may on its construction be triggered by the government lockdown in the UK, but not triggered by supply chain disruption in China. If, even absent of the government lockdown, the business was unable to perform because of supply chain disruption in China then the FM Clause may not assist them.

THE TEAM

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4. Frustration

Test for Frustration

The two classic statements of the law on frustration are:

> *"... frustration occurs whenever the law recognises that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract. Non haec in foedera veni. It was not this that I promised to do.'" (per Lord Radcliffe Davis Contractors v Fareham Urban District Council [1956] AC 696, p729)*

> *"Frustration of a contract takes place when there supervenes an event (without default of either party and for which the contract makes no sufficient provision) which so significantly changes the nature (not merely the expense or onerousness) of the outstanding contractual rights and/or obligations from what the parties could reasonably have contemplated at the time of its execution that it would be unjust to hold them to the literal sense of its stipulations in the new circumstances; in such case the law declares both parties to be discharged from further performance." (per Lord Simon National Carries v Panalpina [1981] AC 675 p700)*

The key question is therefore what circumstances render a contract "radically different" or such that it is "unjust to hold" the parties to it.

Plainly, impossibility of performance of a contract would suffice. Thus, in contracts for personal service, such as sports or music events, a travel ban preventing a performer from attending would frustrate the contract. Similarly, where performance of the contract becomes illegal, for example due to a government mandated lockdown, that would also frustrate the contract.

The more interesting question is where performance is still literally possible, but the contract is "radically different" to that which was contemplated. Thus, in the coronation cases such as Krell v. Henry [1903] 2 K.B. 740, rooms were rented for the purpose of observing Edward VII's coronation procession, which was delayed due to the King's illness. Whilst the lease could still literally be performed, the parties' common purpose – making provision to view the coronation – had been frustrated.

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- disputes relating to the interpretation or breach of most types of commercial contract and trust deed
- claims for breach of fiduciary duty
- freezing injunctions and asset recovery
- cross-jurisdictional issues
- CPR Part 8 claims as well as hostile CPR Part 7 claims for damages and other relief in the context of pensions and other commercial trusts
- banking and financial services
- professional negligence claims
- company law issues

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The modern approach to determining whether an event frustrates a contract is multi-factorial. In The Sea Angel [2007] 2 All ER (Comm) 634 Rix LJ identifies those factors:

> *"the application of the doctrine of frustration requires a multifactorial approach. Among the factors which have to be considered are:*
> - *the terms of the contract itself,*
> - *its matrix or context,*
> - *the parties' knowledge, expectations, assumptions and contemplations, in particular as to risk, as at the time of contract, at any rate so far as these can be ascribed mutually and objectively,*
> - *the nature of the supervening event, and the parties' reasonable and objectively ascertainable calculations as to the possibilities of future performance in the new circumstances.*
>
> *The test of 'radically different' is important: it tells us that the doctrine is not to be lightly invoked; that mere incidence of expense or delay or onerousness is not sufficient; and that there has to be as it were a break in identity between the contract as provided for and contemplated and its performance in the new circumstances."*

Additional expense in the supply chain will be insufficient. Delays caused by Covid-19 are also unlikely to be sufficient unless the delay is so severe that it would fall outside what the parties could contemplate (e.g. The Nema [1982] AC 724) In the right circumstances, an absence of staff to fulfil a contract due to the pandemic might well be sufficient. In all cases the enquiry is an acutely fact sensitive one.

Limits of Frustration

Frustration will not apply where the parties have made express provision for the event which has incurred. Thus, if the event is covered by the FM Clause, it is the FM Clause and not common law frustration which governs the parties' ongoing obligations.

Where the parties have foreseen a particular event, typically frustration will not apply, even if the parties did not make express provision for the event in their contract (e.g. in Tamplin v Anglo-Mexican Peroleum [1916] 2 AC 397 a charterparty was interrupted when the ship in question was requisitioned by the Admiralty during the First World War, one of the reasons the contract was not frustrated was as Lord Parker noted that *"the contract contemplates that though the charterers desire to use the vessel, it may for intermittent periods of indefinite duration be impossible for them so to do."* Thus, parties contracting now when the risks associated with the Covid-19 pandemic are apparent are unlikely to be able to claim that the pandemic has frustrated their contract.

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The frustrating event must be outside the control of the parties; thus, a self-induced frustration will not be sufficient (e.g. Bank Line v Arthur Capel [1919] AC 435, 452). Again, it will be a question of fact whether a business which was not legally required to close by the government, but chose to take precautionary measures and close in response to the pandemic, will be able to take advantage of frustration.

Remedy

At common law, the parties could not recover in respect of their part performance before the frustrating event occurred. Thus, pre-payments could not be recovered, and a party who had incurred expense could not be reimbursed for that expense (see Fibrosa v Fairbarn [1943] A.C. 32).

The Law Reform (Frustrated Contracts) 1943 addresses the deficiencies associated with that approach. In summary:

1. Money paid before the frustrating event can be recovered, and money which was due but not paid, ceases to be payable.
2. A party which has incurred expense in performing the contract prior to the frustrating event may, if the court considers it "just", retain all or part of any sums pre-paid by the other party, or recover all or part of monies which were payable, but not paid, prior to the frustrating event.
3. A party who has received a valuable benefit prior to the frustrating event may be required to pay a "just" sum for it.

When determining what is "just" the court applies a broad discretion which neither requires a party to be fully compensated for expenses incurred, nor requires lost costs to be equally shared (see Gamerco v ICM [1995] 1 WLR 1226, p1235).

5. Material Adverse Change

MAC clauses are often heavily negotiated and their precise impact will require careful construction. Three key points to look out for are:

1. Whether an objective standard must be met for there to be a "material adverse change", or whether the clause requires a determination on the part of the lender/purchaser (for an example of the latter see *Cukurova v Alfa Telecom* [2016] AC 923). Such a determination will typically need to be conducted in a rational manner compliant with the requirements in *Braganza v BP Shipping* [2015] 1 W.L.R. 1661.

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2. Whether the clause is forward looking or backward looking and, if forward looking, whether it specifies that the change "may", "is likely to" or "will" be materially adverse. "Will" is most favourable to the borrower/seller and "may" to the lender/purchaser.
3. Whether the clause is structured as a warranty/representation that there has been no material adverse change offered by the borrower/seller or is structured as a condition.

The case law on MAC clauses is relatively sparse. Perhaps the most useful is Grupo Hotelero v Carey [2013] EWHC 1039 (Comm). The clause in question was in loan documentation and required the borrower to make representations that there "has been no materially adverse change in its financial condition" since the date of the loan agreement. The issue of "material adverse change" was therefore to be determined objectively. The following guidance can be drawn from Blair J's judgment:

1. "Its financial condition" was concerned with the financial condition of the particular borrower. General market conditions were insufficient to trigger the clause.
2. The issue of what is "material" should be determined by reference to the interests which the MAC Clause is seeking to protect. In the context of loans, MAC Clauses protect the lender's right to repayment and so materiality should be assessed by reference to whether the change "significantly affects" the borrower's ability to repay.
3. The word "change" means that the lender/purchaser cannot trigger a MAC clause on the basis of matters known to it at the time of the agreement, or potentially matters it should have foreseen.
4. A temporary change in condition is insufficient to trigger a MAC Clause (see Thomas Witter Ltd v TBP Industries [1996] 2 All ER 573, p605).

In every case it will be a matter of construction after a close analysis of the facts to determine whether the Covid-19 pandemic has triggered a MAC Clause. Some factors which are likely to be relevant in relation to many MAC clauses are:

1. Has the Covid-19 pandemic affected the particular business in question? For example, the service and aviation industries are particularly badly affected.
2. Will the effects on the business be temporary, or will this period of disruption mortally wound it?
3. Is the impact "significant"? In the present circumstances, one would expect this condition to be satisfied often.
4. When was the contract entered into? Should the parties have foreseen the impact of the Covid-19 pandemic at that time?

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Conclusion

FM Clauses, MAC clauses and the doctrine of frustration can provide an escape from contractual obligations in extreme situations such as the current pandemic. However, none necessarily offer a panacea, and in all cases there must be an acute focus on the precise way in which the present circumstances are affecting the business or contract in question coupled with a careful interpretation of the relevant contractual clauses.

Find Out More

This article was written by Andrew Spink QC and Saaman Pourghadiri, members of Outer Temple Chambers' Commercial Dispute Resolution Team. They who would be pleased to discuss any related matter with you in the strictest of confidence.

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