SUPERVENING EVENTS:
EFFECTS ON CONTRACTS IN THE CONTEXT OF COVID-19

A Practical Guide from the 2TG Commercial Team — Summer 2020

Introduction

The COVID-19 (coronavirus) pandemic and ensuing restrictions on business and travel have had an unprecedented effect on the ability of contracting parties worldwide to perform their obligations. Commercial bargains that once appeared advantageous may now be impossible, ruinous or pointless to perform.

This Practical Guide aims to provide an introduction to the approach to supervening events under English law, particularly in relation to force majeure clauses and frustration.

Express Provision in the Contract

The first port of call, as always, is to the express contractual terms. In that regard, this Practical Guide focusses on force majeure clauses, but parties should also bear in mind other clauses that may be relevant, such as:

- *Cancellation and termination provisions*: It may be possible to avoid any, or any further, contractual performance by bringing the contract to an end pursuant to mechanisms provided in the contract.

- *Material adverse change clauses/events of default:* The contract may make express provision for what is to occur if there is an adverse change in a party's position or financial circumstances, which may well be impacted as a result of COVID-19.

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Force Majeure Clauses

Commercial contracts will often contain what are known as force majeure clauses. The phrase "*force majeure*" is not a term of art and force majeure clauses come in varying shades of specificity and detail. Their general effect is to enable a contracting party to suspend performance under a contract, or in some cases to terminate or cancel the contract, upon the occurrence of supervening events beyond its control.

Reliance on a force majeure clause is typically a matter of election and clauses often expressly set out how notification of such election is to be given. Contrary to the position with frustration (which arises automatically), contracts may be unaffected by the happening of a force majeure event, unless a contracting party elects to rely on the same. Whether any election or notification is necessary will, however, ultimately depend on the clause in question.

There is a (somewhat technical) debate as to whether force majeure clauses are properly to be considered as exclusion clauses and thus interpreted strictly against the party relying upon the clause. The best view is that, although they are not paradigm exclusion clauses (*Fairclough Dodd & Jones v JH Vantol* [1957] 1 W.L.R. 136, 143) and should be interpreted neutrally, it is nevertheless necessary for a party seeking to rely upon a force majeure clause to prove that the circumstances fit "*squarely*" within the scope of the clause, given that the effect of the clause will typically be to excuse bargained for performance (see *Channel Island Ferries v Sealink United Kingdom* [1988] 1 Lloyd's Rep 323, 327). Moreover, as force majeure clauses entitle a party to render performance substantially different from that contracted for (or to render partial or no performance) they are amenable to review under section 3(2)(b) Unfair Contract Terms Act 1977, or equivalent consumer protection legislation (where applicable). Whilst such clauses (given that they are normally focussed on unforeseen events) will typically be regarded as reasonable, it is always necessary to analyse the clause in question.

Whilst each case will, of course, rest upon its own facts and the relevant contractual terms, the key criteria for a party seeking to rely upon a force majeure clause are set out below. There is likely to be a degree of overlap between the criteria, as the provisions of force majeure clauses and the general policy of the law in this area is to ensure that a party can only rely upon a force majeure clause where its inability to perform is truly outside its control and was not a risk allocated to it under the contract in any event.

Has there been a supervening event or occurrence within the scope of the clause?

This will primarily be a matter of contractual construction, with some force majeure clauses providing a specific list of circumstances when they will apply, while others are expressed in more general terms.

More detailed clauses may specifically define a "*force majeure event*" as including a defined list of circumstances, perhaps specifically including an epidemic or pandemic or import or export restrictions imposed by government. In such cases, the focus will be on the causal effect of the force majeure event or events referred to by the clause. Alternatively, a short-form force majeure provision may apply to all events beyond the party's reasonable control. Albeit such a clause may initially appear to be of broader application, it places further emphasis on the question whether the event relied upon was truly outwith the party's control.

Depending upon the wording of the clause, simply relying upon the COVID-19 pandemic generally as the cause may well be insufficient. One may have to consider whether the true 'trigger' that prevented or hindered performance was, for

example, changes of travel advisory guidance from the FCO or other countries, general impecuniosity arising from the pandemic, business restrictions, the UK Government 'lockdown' and/or subsequent breakdowns in supply chains or staff availability. Depending, as ever, on the precise wording of the clause, special attention will need to be paid as to what was the true cause of the inability to perform and whether it fits within the scope of the clause.

Issues may arise in the context of COVID-19 where a force majeure clause, which would otherwise apply, excludes events which are "*foreseeable*" at the time of contracting. For contracts entered into after reports of the outbreak in Wuhan were picked up by the Western media, but before the widespread outbreaks in Europe, there are likely to be issues of whether the ensuing pandemic and restrictions were (sufficiently) foreseeable at the time, and thus not within the scope of a force majeure clause.

The party been prevented, hindered and/or delayed (as required by the clause) from performing because of the supervening event or occurrence

Different force majeure clauses require different levels of impact upon the promised contractual performance before they are effective.

Notably, clauses that require performance to have been "*prevented*" set a higher hurdle than those which require only that performance has been "*hindered*" or "*delayed*".

Whilst dependent upon the particular terms of any contract, the "*prevention*" of performance normally requires that performance has become physically or legally impossible, and not merely more difficult or unprofitable (see *Thames Valley Power v Total Gas & Power* [2005] EWHC 2208 at [50(4)]). Given that the UK Government's response to the COVID-19 pandemic has been a mixture of legal *prohibitions* under The Health Protection (Coronavirus, Restrictions) (England) Regulations 2020 and public health *guidance*, both of which have evolved and which are likely to continue to evolve with the passage of time, there may be complex factual questions as to whether performance was legally or factually impossible at certain points in time.

By contrast, "*hinderance*" or "*delay*" may occur where supervening events make it unreasonably difficult for a party to perform whether at all or at the specified time, even if performance remained theoretically possible (see *Tennants Ltd v Wilson & Co* [1917] AC 495, 510). In the context of COVID-19, a party may be able to rely upon a force majeure clause with the "*hindrance*" standard, even when performance would not be illegal or impossible, but where following UK Government *guidance* would make performance unreasonably difficult.

The non-performance is due to circumstances beyond the party's control or for which the party has not otherwise assumed responsibility under the contract

As force majeure clauses apply to relieve a party of contractual obligations that would otherwise apply, in order not to undermine the primary contractual bargain between the parties, they are normally construed on the basis that the reason for a party's non-performance is: (a) outside its control and (b) not one for which risk is already allocated elsewhere within the contract (see *Fyffes Group v Reefer Express Lines* [1996] 2 Lloyd's Rep 171, 196).

Point (a) requires a factual analysis, but in the context of COVID-19 the outbreak of the virus and ensuing governments' actions are likely to be outside the control of most contracting parties. This may, however, raise interesting questions where one contracting party is an emanation of the state and the force majeure trigger relied upon is a government regulation.

Point (b) is a subtle but important point, namely that (save in the event of specific terms to the contrary) force majeure provisions will not allow a party to override a specific contractual allocation of risk, as this would serve to weaken the parties' primary responsibilities under the contract. For example, where a sub-contract is otherwise clear that payment of the sub-contractor is not dependant upon the main contractor being paid by the client, a main contractor would struggle to rely upon force majeure provisions in respect of any non-payment if its client was unable to pay; the risk of non-payment by the client has been allocated to the main contractor irrespective of a force majeure clause.

There were no reasonable steps that the party could have taken to avoid the consequences of the supervening event

This requirement aims to ensure that parties cannot rely on force majeure provisions to avoid having to take steps in mitigation to fulfil their primary contractual obligations.

Although the practical effect of this requirement will be fact specific, a force majeure clause will generally be interpreted as imposing a positive duty on the contracting party to take reasonable steps to avoid or minimise the effects of any supervening event. As memorably stated by Lord Esher MR in *Bulman & Dickson v Fenwick & Co* [1894] 1 QB 179, the concept of force majeure does not entitle a party to "*fold their arms and do nothing.*"

Reasonable steps might require a party to consider the commercial interests of its counterparty in trying to provide contractual performance, but it would not require the party to subsume its interests to those of its counterparty (see *Reardon Smith Line v MAFF* [1963] AC 691, 729-730 *per* Lord Devlin). For example, if one supply chain is disrupted by COVID-19, a seller of goods cannot generally rely on force majeure provisions if alternative goods are available from another supply chain even if they are at a higher price (see *Tennants v CS Wilson & Co* [1917] AC 495), but matters may be different if the increased price of the supply was of such a magnitude that it would threaten the very viability of the seller's business.

Other Considerations

Where a party can show that the circumstances fall within the scope of a force majeure provision, three further matters should be kept in mind:

- Force majeure clauses frequently provide for notice to be given or for certain steps to be taken by the party seeking to rely on the clause. In a perfect world these formal requirements will be complied with. However, a failure to comply with such formal requirements is not always fatal. Such a failure will only preclude a party from being able to rely upon a force majeure clause where those requirements are seen to be a 'condition precedent' to the operation of the clause (this tends to require some specific wording). In any event, the need to comply with formal requirements may be 'waived' by the other contracting party (see *Bremer Handels v Vanden-Avenne Izagem* [1978] 2 Lloyd's Rep 109). Whether there has been such a waiver, or alternatively an estoppel by representation, will be decided on general contractual and equitable principles.

- Express force majeure provisions, or other contractual terms may 'crowd out' the application of the doctrine of frustration (discussed below) as courts will give precedence to provisions specifically agreed by the parties in respect of a force majeure event, or to the allocation of risk, over the general doctrine of frustration. However, importantly, the doctrine of frustration may still be available where the force majeure

clause in question does not make *"full and complete"* provision for the supervening event (*Bank Line Ltd v Arthur Capel & Co* [1919] AC 435). Whilst force majeure provisions may provide for the termination of the contract, they typically seek to preserve it. So, for example, in standard form construction contracts, force majeure clauses will normally only provide for a delay in the completion of the project, rather than its abandonment. Temporary suspension of performance will not assist a party who remains unable to perform even when the suspension is lifted, or when performance at a later date is pointless, and the doctrine of frustration may come into play instead.

- Certain contractual terms will survive even if the contract is cancelled or terminated under the relevant force majeure provisions. These will include severable terms, such as jurisdiction or arbitration clauses.

Outside the Contractual Terms: The Doctrine of Frustration

The doctrine of frustration is a common law doctrine, modified by the Law Reform (Frustrated Contracts) Act 1943 ("the 1943 Act") in respect of some of its consequences, which aims to provide a safety valve against the rigour of the common law's traditional insistence on the absolute nature of contractual obligations.

Compared to the (relative) certainty provided by a detailed force majeure clause, the doctrine of frustration is one which is intended to be flexible and capable of application to fresh circumstances (see *National Carriers Ltd v Panalpina (Northern) Ltd* [1981] AC 675). Against this, there is a constant countervailing pressure to keep the doctrine within narrow limits, to avoid undermining commercial certainty and relieving parties from imprudent bargains. In practice, frustration is not easy to establish.

Whether there has been a 'frustrating' event is a matter of law (see *Davis Contractors v Fareham UDC* [1956] AC 696). Moreover, frustration is a definite event and the fact that the parties may not treat a frustrating event as such does not change the position in principle (see *Armchair Answercall v People in Mind Ltd* [2016] EWCA Civ 1039 at [51]). It arises automatically, without election. This means that, in principle, a contract may have been 'frustrated' even if the parties are not treating it as such and are trying to salvage what can be obtained from their agreement, albeit in that situation it may be possible to say that a new contract has come into existence.

The classic overarching test for frustration was set out by Lord Simon in *National Carriers v Panalpina (Northern) Ltd* [1981] AC 675, at page 700, as requiring three main elements, namely a supervening event:

- which is not the fault 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 obligations from what the parties could reasonably have contemplated at the time of its execution;

- such that it would be unjust to hold the parties to the literal sense of the contract's stipulations in the new circumstances.

The first requirement, that there needs to be a supervening event which is not the fault of either party and for which the contract makes no sufficient provision, incorporates two separate points.

- *No contractual allocation of risk*. As discussed above in the context of *force majeure* provisions, a contract will not be frustrated

where the risk of an event has been allocated to a party upon the true construction of the contract. Courts will search hard to find such an allocation of risk in the terms, especially in the case of detailed contracts negotiated by commercial parties. The search for a contractual allocation of risk can be seen in the recent case of *Canary Wharf v European Medicines Agency* [2019] EWHC 335 which arose out of the EMA relocating from Canary Wharf to Amsterdam following Brexit. The EMA's case was that the lease on its Canary Wharf offices was frustrated because of the UK ceasing to be an EU member state. However Marcus Smith J held that, as the lease expressly permitted the EMA to sub-let or assign the lease (albeit subject to burdensome conditions), the risk of the EMA not being able to use the Canary Wharf offices in the future was allocated to the EMA by reason of the sub letting provisions, such that the doctrine of frustration was not applicable. This underlines that a detailed analysis of the relevant contractual provisions will be necessary before concluding that a contract has been frustrated. The fact that the contract does not refer to pandemics or government shutdowns does not mean that the risk of such events has not been allocated by the contract.

- *Not self-induced.* The doctrine of frustration does not apply where the frustrating event is the result of one party's actions. The classic example of this is the well-known case of *The Super Servant Two* [1990] 1 Lloyd's Rep 1. The contract in issue provided that one of two vessels could be used to transport a drilling rig. One of the vessels sank shortly before the contract was to be performed, at which point the other vessel had been engaged to satisfy other contracts. The Court of Appeal held that the inability to perform the original contract was self-induced, in that it arose out of the defaulting party entering subsequent contracts, not merely the sinking of one of its ships. This could well be a real issue in COVID-19 cases where companies, operating with just-in-time inventories to increase profitability, are unable to cope with even modest disruption to their supply chain. It may be argued that such lack of resilience is self-induced.

The second requirement is that the supervening event radically changes the nature (not merely the expense or onerousness) of the outstanding contractual rights and obligations from what the parties could reasonably have contemplated at the time of its execution.

The test is objective (*Davis Contractors v Fareham UDC* [1956] AC 696, 728 *per* Lord Radcliffe). As such, the fact that the parties in question in fact foresaw the possibility of the event or new circumstances in question does not *necessarily* prevent the doctrine of frustration from applying. However, it will obviously be difficult to persuade a court that a risk actually foreseen by the parties in question would not have been within the contemplation of a reasonable person in their place.

Although this test is broad enough to apply to all types of supervening events, and it is impossible to categorise all types of frustrating event, the paradigm categories are often broken down as:

- *Impossibility of agreed performance.* For example, the supervening illegality of the performance of a contract will render it impossible to perform. See for example, *Metropolitan Water Board v Dick, Kerr & Co* [1918] AC 119, where a contract for the construction of a reservoir was frustrated by an order of the Ministry of Munitions forbidding works on the same for an extended period. In the context of COVID-19, one can see how contracts requiring personal attendance or the opening of retail facilities prohibited by The Health Protection (Coronavirus, Restrictions) (England)

Regulations 2020 may fall into this category. It should be noted that illegality may separately also amount to a defence to a claim for enforcement of a contract. This is outside the scope of this Practical Guide but see generally *Patel v Mirza* [2016] UKSC 4. The doctrine of illegality may have particular relevance where the conduct was already illegal at the time of the contract (for example, a contract to put on a concert after the coming into force of the Health Protection (Coronavirus, Restrictions) (England) Regulations 2020).

- *Impossibility of the agreed purpose of the contract*. This concept is normally explained by reference to two cases arising out of the cancellation of Edward VII's coronation in 1902, albeit they themselves are exceptional. *Krell v Henry* [1903] 2 KB 470 concerned the hire of rooms from which to watch the coronation and *Herne Bay Steamboat Co v Hutton* [1903] 2 KB 683 concerned the hire of a boat to watch a naval review scheduled for the coronation date. Only *Krell* was found to be an example of frustration on the basis that the only purpose of the hire of the rooms was to watch the coronation, whereas there was still a residual benefit from a boat trip, even if the naval review did not take place.

- *Delay*. Although the concept of delay is self-explanatory, in order to frustrate a contract, any delay must be abnormal in its cause, its effects, or its expected duration, so that it falls outside what the parties could reasonably contemplate at the time of contracting (see *Sir Lindsay Parkinson & Co Ltd v Commissioners of Works* [1949] 2 KB 632).

The third element of the test for frustration, namely that it would be unjust to hold the parties to the literal terms of the contract given the supervening event, may appear to set a vague, or not particularly high, bar in principle. However, in practice, to establish that it would be unjust requires a significant change from the reasonably contemplated state of affairs from the time of contracting. This is consistent with the courts' general desire to uphold the parties' primary contractual rights and obligations.

The effect of frustration is to discharge a contract, cancelling all current and future rights and obligations. Therefore, the requirement on a party to provide further performance is discharged upon the occurrence of a frustrating event.

However, the contract is not treated as if it never existed (i.e. the contract is not voided *ab initio*) and certain clauses, such as those which concern arbitration or jurisdiction, will survive.

At common law, the consequences of discharge were stark. Unless there was a total failure of consideration, there was no scope for any recovery of monies paid. And the scope for a *quantum meruit* in relation to any work done was very limited.

The 1943 Act sought to modify some of the defects of the common law. In particular section 1(2) provides that monies paid over or payable before the frustrating event are recoverable, or no longer payable as the case may be, save that where expenses have been incurred the court may, if it considers it just, allow the party who has incurred the expenses to retain or recover the whole or any part of the sums paid or payable, up to the sum of the expenses. Section 1(3) conversely provides that where a party has obtained a valuable benefit (other than money), the court may order the party receiving the benefit to pay a sum not exceeding the value if the benefit. It should be noted that the 1943 Act does not apply to all types of contract (including insurance contracts and certain charterparties) – in those cases the common law applies.

The effect of the 1943 Act is probably best explained in the context of a contract for refurbishment works that is frustrated at the point of being partially completed. The client will generally have obtained some benefit from any part of the works that have been completed, meaning that the contractor can recover a just sum representing the benefit received by the client (under section 1(3)). Conversely, an employer can recover money paid over to the contractor before the frustrating event, save for allowing the contractor a 'just' sum up to the amount of the expenses incurred (section 1(2)).

The assessment of claims under the 1943 Act is by no means well settled and remains controversial. Compare, for example, the flexible approach to assessment under section 1(2) adopted in *Gamerco v ICM/Fair Warning* [1995] 1 WLR 1226 and Goff J's (albeit *obiter*) narrow analysis of the same provision in *BP Exploration v Hunt* [1979] 1 WLR 783). This is likely to be a source of argument in claims arising out of the COVID-19 pandemic.

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