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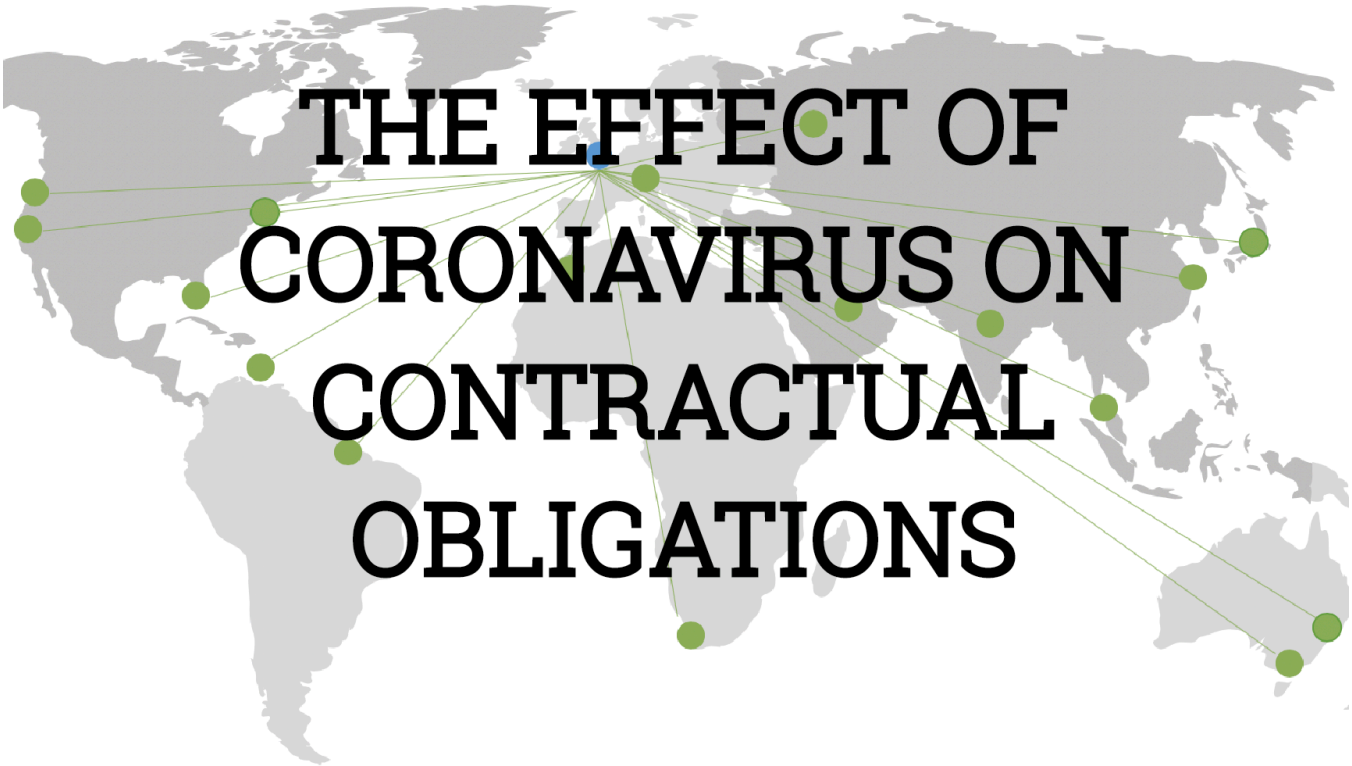

THE EFFECT OF CORONAVIRUS ON CONTRACTUAL OBLIGATIONS

Introduction

The Covid-19 coronavirus outbreak is already having a significant impact on many individuals and many businesses. Unfortunately, it is becoming clearer that the impact will likely be more significant and longer lasting than we may have imagined at first.

Primarily, businesses should be focussed upon the health and wellbeing of their teams, and what they can do operationally to minimise the spread of the virus. Governments across the world are issuing guidance, and mandating actions, that businesses and individuals must take to support this effort. That is a fast-moving landscape. We are working hard to keep our clients up to date. Obviously, businesses and individuals must comply with whatever local rules and guidance are put in place.

This note provides legal analysis alongside some valuable, practical steps that may be taken by parties who find the impact of Covid-19 affects their ability to meet contractual obligations owed to others (upstream), or who find that their trading partners can no longer meet the obligations owed to them (downstream).

In the modern commercial world, businesses are also more reliant on trading partners and long "just in time" supply chains in order to fulfil their contractual obligations. The impact of Covid-19 could significantly upset those finely balanced arrangements. The relationships between parties may be tested in ways they had not previously contemplated.

As trading relationships are now often global, one may have to consider a complex interplay of laws from different jurisdictions, some of which are potentially in conflict. The answers are not simple to come by and are highly fact specific. This note gives some general legal guidance, but it is no substitute for proper legal advice – whether that advice comes from us, or your usual lawyers.

It is also important to state that various governments are introducing emergency legislation to provide support to businesses that may be affected by Covid-19. Some of that legislation may amend the general legal guidance provided in this note. For countries that are key for our clients, we will endeavour to provide advice on the latest position.

Initial practical steps

At this time, we recommend all businesses undertake some simple, practical, due diligence. Taking the following steps would be sensible:

- Before launching into any sort of legal review, take a step back and review your current customer work demands and ongoing projects:
    - Assess the extent to which your own, internal ability to meet commercial commitments given to your customers and suppliers are likely to be affected by Covid-19. Will you need to rely on some of the contractual protections that may be available to you?
    - Assess the extent to which your ability to meet commercial commitments is dependent upon your supply chain partners meeting their commitments to you. Make sure you understand how multi-tiered your supply chain is, and where the risk of disruption sits.
    - Assess whether those supply chain partners can meet their commitments. In that assessment, consider the risk of insolvency of supply chain partners.
    - Create your risk assessment, identifying those areas where you believe there is a risk of failure.
    - Update financial forecasts and project programmes accordingly.
- Consider what reasonable steps you might take to eliminate, or at least mitigate, the effects of Covid-19, and what reasonable steps you might ask (or require) others to take. What is your Plan B for potentially failing suppliers? Are there alternative suppliers you can use? Will these steps require a change to existing contractual commitments, or can they be managed within the existing framework? Establish when you need to put those steps into action.
- Where you identify that you can perform some, but not all, of your obligations, it will be necessary to consider which commitments you prioritise. This analysis will need to consider the consequences of underperformance on non-priority commitments – from a commercial, legal (see below) and reputational standpoint. If you are regulated body, what requirements does your regulator impose?
- Determine what pre-emptive communication you need to have with your customers, suppliers and other stakeholders. Consider whether a collaborative approach might assist in practical management of the issues and the establishment of contingencies. An appreciation of the legal ramifications (contained in this note) might support your efforts to negotiate sensible, practical variations to the contracts.
- Keep records of the ongoing impact Covid-19 has had on your performance, since this may be useful if a dispute arises. However, do consider that those records may become disclosable in the event of a dispute – so you might want to engage lawyers to take advantage of legal privilege.
- Discuss with your insurance brokers whether you are able to rely on any policies of insurance (for example, business interruption) and ensure you comply with any applicable claims notification procedures.

What does the law say?

It will be important to establish what legal rights you have, and what you might need to do in order to preserve those rights. The starting point is to review the relevant contracts and agreements (including standard terms on purchase orders, etc).

Once you have identified the applicable contracts, identify which jurisdiction governs them. In some circumstances, you may need legal input to determine which set of terms actually governs a particular relationship. The laws appliable in different countries can vary quite widely. You may find a mismatch within the same project – for example, English law may govern your contract with your customer, but Chinese law may govern the law of your contract with a critical supplier enabling you to perform your customer contract. This creates a complexity and a risk.

Identify whether there are any express provisions written into the contract which might be relevant to the Covid-19 situation. For example, we would consider clauses dealing with the following to be highly relevant (but this is not an exhaustive list):

- Force majeure;
- Extensions of time;
- Material Adverse Change (or Material Adverse Effect);
- Changes in law;
- Frustration and illegality;
- Price adjustment mechanisms and currency fluctuations;
- Financial uncertainty of a party (including insolvency);
- Insurance;
- Notice provisions;
- Limitation and exclusions of liability; and
- Jurisdiction and dispute resolution (see above).

Force majeure

The concept of force majeure comes from French law and, broadly speaking, provides relief to parties from their contractual obligations if an event outside their control arises. The law related to force majeure is highly country specific. There are two broad approaches: common law and civil law.

In most common law jurisdictions, the position on force majeure will be solely governed by the contract. Force majeure will generally not be implied as a matter of law. The express contractual mechanism will be strictly applied and interpreted. There will be an assumption that the parties are responsible for adhering to whatever they have agreed to. In a common law jurisdiction, if a contract does not include a force majeure provision, the parties are very unlikely to be able to rely on the concept of force majeure, but may be entitled to other types of relief described in this note. Common law jurisdictions include the United Kingdom and many of its former colonies, the Republic of Ireland, the United States and most Commonwealth countries.

In many civil law jurisdictions, there will be a Civil Code which will usually define what constitutes an event of force majeure and what the parties' rights will be if such an event arises. The legislation may permit the parties to amend, extend or limit the legislative provisions by way of express terms of the contract, or the legislative provisions may prohibit such amendment. Civil law jurisdictions include many countries in Europe and their former colonies, Scandinavia, Turkey, and many Asian countries including China.

Many countries in the Middle East have also codified a principle of "hardship events", based on Sharia law. For the purposes of this note, we consider that to be broadly equivalent to the concept of force majeure under civil law jurisdictions. Specific consideration to the relevant Codes is required (for example, Article 249 of the UAE Civil Transactions Law and Article 171 of the Qatari Civil Code).

In the context of Covid-19, we believe a force majeure event might arise in some jurisdictions in one of two ways:

- the fact of Covid-19 itself and the impact that has on workforce availability down through the supply chain; and

- sanctions and prohibitions ordered by governments and other regulatory bodies as a consequence of Covid-19 that go on to affect performance of a contract.

Common features of force majeure provisions (whether contractual or legislative) include:

- A definition of what comprises a force majeure event. This may be specific (for example, it may list a pandemic or governmental action) or may be defined more broadly (for example, *"acts of God, flood, drought, natural disaster, war, or any other cause beyond the control of a party"*). It may also list consequences that have been brought about by Covid-19 (for example, it may list *"a general shortage of labour"*). It is necessary to consider the precise wording to establish whether or not a force majeure event has been triggered. Usually, it is the person wanting to rely on force majeure who has to demonstrate that the relevant provisions have been triggered.

- A requirement that the event claimed to cause force majeure was not foreseeable by the parties at the time the contract was entered into. Timing is everything, and this could be a very relevant provision for contracts that are currently undergoing negotiation and are yet to be entered into, or have been entered into since Covid-19 became apparent.

- A requirement that the consequences of the event claimed to cause force majeure were not foreseeable by the parties at the time the contract was entered into. This is subtly different to the point above. Again, timing of entering into the contract is relevant. A party may have been aware of the existence of Covid-19, but have had no idea of the potential consequences it has had.

- A requirement that it is the force majeure event that has caused the party's failure to perform the contract. So, for example, a party should not be able to use force majeure where it would have failed to perform anyway, regardless of Covid-19.

- The parties being required to mitigate the effects of a force majeure event as far as reasonably possible.

- Express notice provisions which must be complied with for a party to take advantage of the force majeure protections. It will be important to comply with these to the letter.

- The relief offered by force majeure provisions may also vary. Generally, a force majeure event will entitle a party to relief from performance, and from the risk of a default termination of the contract. The affected party usually receives an extension of time to comply with their obligations. Generally, they are not entitled to recover additional costs, although this also depends upon the precise wording. The wording may provide that, if a force majeure event occurs over a prolonged period, one or both parties has a right to terminate the contract.

As regards force majeure, we are currently providing our clients with (i) general advice on the laws in key jurisdictions to them and (ii) specific advice on the terms of their particular contracts.

Material Adverse Change clauses (also known as Material Adverse Effect clauses)

Certain contracts (particularly in debt finance and mergers and acquisitions) contain material adverse change or material adverse effect clauses. These provisions usually allow one party to walk away from the contract if a party suffers a material adverse change or there is a material adverse effect on the party from an external event. The operation of the clause, and the relevant factors to take into account, are similar to force majeure clauses described above. You will first need to determine whether the threshold has been met for Covid-19 to trigger the relevant provisions.

Change of law clauses

The occurrence of Covid-19 is likely to result in governments changing certain laws. Long term contracts often contain change of law provisions. Moreover, a government introducing changes to legislation may also write into the legislation itself provisions to deal with the consequences of that change to commercial parties.

Where they exist, change of law clauses in contracts may require the parties to use best efforts to renegotiate the bargain, or may entitle a party to terminate.

Frustration

Many legal systems provide that a contract may be brought to an end for frustration, where some event occurs after the contract was executed that makes it impossible to fulfil the contract, or transforms the obligation to perform into a radically different obligation.

In common law countries, where the parties have not included a force majeure clause in their contract, frustration may be a mechanism. It is important to note, however, that frustration is hard to prove and, in practice, frustration is seldom available to parties as a relief. Obviously, there is very little guidance at the moment from the courts in any jurisdiction upon how likely parties will be able to rely on frustration for Covid-19.

Price adjustment mechanisms and currency fluctuations

As stated above, force majeure provisions generally entitle the affected party to additional time for the performance of its obligations, but do not generally entitle the affected party to recover additional costs and expense through the contract. Some contracts, however, will contain price adjustment mechanisms.

Covid-19 is having significant impact upon global economic markets. This is likely to affect currency exchange rates. Many contracts contain provisions dealing with exchange rate fluctuations.

Financial uncertainty and insolvency

Where the consequences of Covid-19 bring into question the financial viability of a contracting party, businesses may be able to rely on contractual provisions related to financial uncertainty and, in extreme situations, termination rights linked to insolvency.

Are you likely to be insured?

Certain insurances might respond to Covid-19, but most businesses will probably find they have little or no recourse to insurance.

There is a lot of talk about business interruption insurance. The reality (in the UK at least) is that most businesses will find they have little or no recourse to business interruption insurance. Business interruption insurance is usually written as an add on to a property damage policy. It would cover losses arising from physical damage to property, but it is not usually an all-encompassing policy covering risks of interruption to your business. Having said that, policies do exist that provide broader coverage and some businesses may have coverage. It will be important to consider the specific terms of your insurance.

Credit risk insurance may respond if a party fails to make payment on a contractual commitment. However, this cover usually only applies if the party remains contractually obliged to make payment and fails. So, for example, if a party is excused from payment due to a material adverse change clause in the contract, any credit insurance policy is unlikely to respond.

If you believe you may have insurance coverage, it will be very important to follow all relevant procedures in the policy related to claims notification and submission of claims.

How can Conexus Law help?

Businesses and individuals will need legal advice to help them understand the risks they may face and the options that may be open to them. We are available to assist in reviewing the laws in many jurisdictions across the world, and to review specific contracts. We are also available to provide practical, business-orientated advice on how to best protect yourself from the ongoing commercial effects of Covid-19.

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