HERBERT SMITH FREEHILLS
DISPUTE RESOLUTION

WHEN EVENTS INTERVENE:

FORCE MAJEURE, FRUSTRATION AND MATERIAL ADVERSE CHANGE

CONTRACT DISPUTES PRACTICAL GUIDES
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This is the seventh in our series of contract disputes practical guides, designed to provide clients with practical guidance on some key issues that feature in disputes relating to commercial contracts under English law.

When events take a dramatic turn, parties may be left unable to perform their contractual obligations, or may find that their counterparty is unable or unwilling to perform. In such circumstances, a party may be able to rely on contractual provisions, such as a force majeure or material adverse change (MAC) clause, to suspend its contractual obligations or to avoid them altogether. Alternatively, a party may argue that the contract has been brought to an end automatically as a result of the doctrine of frustration.

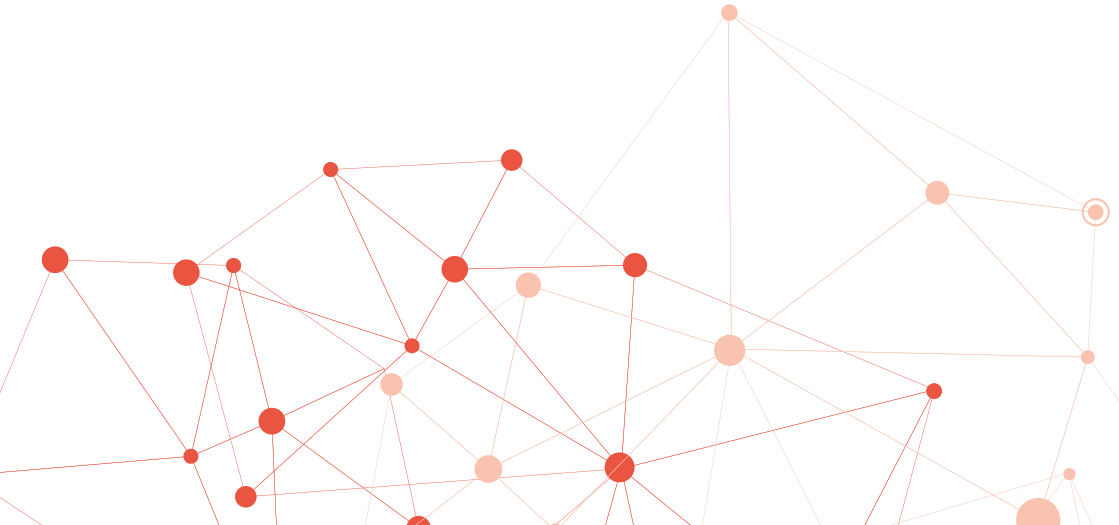
The question of when a party can suspend or avoid performance due to an intervening event or change of circumstances has gained particular prominence in recent years, initially in anticipation of Brexit and more recently in light of the disruption caused by the Covid-19 pandemic.



Neil Blake, Julie Farley and **Natasha Johnson** consider when such rights or principles may be triggered, as well as some practical steps that contracting parties can take to protect their position.

TOP TIPS FOR FORCE MAJEURE, FRUSTRATION AND MAC:

- DON'T assume that an occurrence will be covered so long as it falls within the list of force majeure events – it must also affect a party's ability to perform the contract
- DO remember that an event which makes the contract more onerous or less profitable will not necessarily trigger the clause
- DO strictly comply with any notification requirements under the contract
- DO ensure you do what you can to mitigate the effects of the force majeure event, whether or not there is an express obligation to mitigate
- DO continue to monitor the situation to ensure you are ready to recommence performance as soon as the force majeure event has ceased to have an impact
- DON'T assume that all force majeure clauses are equal: the relief available will depend on the wording of the clause
- DO think carefully about the force majeure or MAC provisions in new contracts, taking into account which party is most likely to seek to rely on the clause
- DO consider whether a force majeure clause should require prevention of performance or some lesser threshold (eg delay, hindrance)
- DO consider what should or should not be covered by a force majeure clause, particularly given the continuing effects of the Covid-19 pandemic
- DO think carefully and take legal advice before exercising a right to terminate the contract under a force majeure or MAC clause, or asserting that the contract has been frustrated



1. Introduction

A dramatic or unexpected event or change of circumstances, such as Brexit or the Covid-19 pandemic, will often cause commercial parties to reconsider their contractual arrangements. This may be because the party itself, or a counterparty, is facing difficulties in performing its obligations, or it may be because the contract has become uneconomic in light of the changed circumstances.

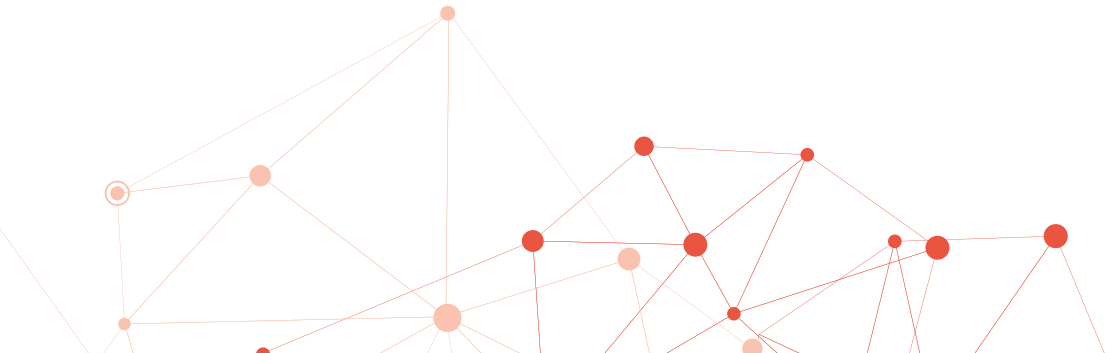
In some such circumstances, a party may be able to rely on contractual provisions to suspend its contractual obligations or to avoid them altogether. The most common types of clause that fall into this category are:

- A force majeure clause: This is a term found in many contracts which excuses one or both parties from performing their obligations if they are prevented from doing so by circumstances outside their control. Force majeure clauses are considered at section 2 below.
- A material adverse change (or "MAC") clause: This is a term found in some agreements which allows a party (for example a buyer or lender) to refuse to proceed if certain events occur after the contract date. MAC clauses are considered at section 3 below.

Where the contract does not contain a force majeure or MAC clause (or, potentially, if such clauses do not apply), a party may be able to argue that the contract has come to an end automatically as a result of the doctrine of frustration. This applies where an event occurs after the contract has been entered into, which is not due to the fault of either party, and which makes further performance impossible or renders the obligations radically different from what was contracted for. Frustration is considered at section 4 below.

Of course, as an alternative to relying on a force majeure or MAC clause or claiming that the contract has been frustrated, a party may seek to terminate the contract either under an express contractual right or alternatively under the general law as a result of a counterparty's repudiatory breach. Termination will be considered in the next issue in this series of contract disputes practical guides.

"In times of great upheaval, such as we are seeing with Covid-19, there will inevitably be disruption to many commercial arrangements – and some parties may be looking for a way out"



2. Force majeure

The term "force majeure" does not have a standard or recognised definition in English law. The application and effect of a force majeure clause depends on the language used in the agreement.

A typical force majeure clause will excuse one or more parties from performing their contractual obligations if they are prevented (or, depending on the scope of the force majeure clause, if they are hindered or delayed) from doing so by an event or circumstances outside their control. In considering whether a force majeure clause can be invoked there are a number of points to consider:

- Does the event fall within the definition of force majeure under the contract?
- Has the event had the requisite effect on performance?
- Are there requirements that must be satisfied before the clause can be relied on, such as notification or mitigation?
- What is the effect of reliance on the clause?

Definition of force majeure

Force majeure will often be defined by reference to a non-exhaustive list of events, together with a general "wrap-up" provision to include other events which are not within a party's reasonable control. Some clauses may, however, be in short form, omitting the list of events and simply referring to circumstances beyond a party's reasonable control, or similar wording. Conversely, some clauses may define force majeure by reference to an exhaustive list of events.

Whether a particular event, such as the Covid-19 pandemic or related restrictions, may qualify as force majeure will depend on whether it falls within the list set out in the clause, or any general "wrap-up" provision for events beyond the parties' control. Common categories of force majeure event which may be relevant in the context of the Covid-19 crisis include epidemic or pandemic, changes in law or regulation, acts of governmental authorities, and delays in transportation or communications.

Effect on performance

A force majeure clause will generally be triggered only if the event has the requisite effect on a party's performance of its contractual obligations. The clause may require that the event prevents performance, or it may be drafted more broadly to refer to an event which prevents, hinders or delays performance (or similar wording).

A change in economic or market circumstances which makes the contract less profitable is not generally sufficient to trigger a force majeure clause. An event or circumstance which makes performance more onerous is also unlikely to be sufficient, at least where the clause refers to performance being prevented; there may be more flexibility where the clause refers to hindrance or delay. All will depend on the proper construction of the clause.

"Force majeure is not a term of art. What constitutes force majeure will depend on the terms of the contract and the impact on performance."

In *Thames Valley Power v Total Gas & Power* [2005] EWHC 2208 (Comm), the High Court found that a force majeure clause in a gas supply contract was not triggered by a sharp rise in the market price of gas, making it uneconomic for the seller to supply the gas.

The court agreed with the buyer that the increased cost of gas did not mean the seller was unable to carry out its obligations under the agreement; it merely made the contract less profitable. This was not sufficient. The fact that a contract has become expensive to perform, or even dramatically more expensive, is not a ground to relieve a party from performance on the grounds of force majeure (or indeed frustration).

Similarly, in *Tandrin Aviation Holdings v Aero Toy Store* [2010] EWHC 40 (Comm), the High Court found there was no triable argument that a force majeure clause in an aircraft sale agreement was triggered by the "unanticipated, unforeseeable and cataclysmic downward spiral of the world's financial markets".

The court referred to the well-established position under English law that a change in economic or market circumstances which affects the profitability of a contract or the ease with which the parties' obligations can be performed is not regarded as being a force majeure event.

It is sometimes argued that a party cannot rely on force majeure because the force majeure event was not the cause of the non-performance. Typically, this argument may be run in two different ways:

- the party could have performed its obligations despite the force majeure event (had some other occurrence not got in the way), so it was not the sole or effective cause of the non-performance; or
- the party could not have performed its obligations even if the force majeure event had not occurred – ie the party cannot meet the "but for" test of causation because it cannot be said that "but for" the force majeure event it would have been able to perform.

Ultimately, the precise causation requirements in a given case will depend on the construction of the particular clause, as the cases referred to below demonstrate.

"The fact that performance has become more expensive or less profitable than you expected will not generally mean you can rely on force majeure."

In *Seadrill Ghana Operations Ltd v Tullow Ghana Ltd* [2018] EWHC 1640 (Comm), the High Court considered a clause in a contract for the hire of an oil rig. The clause provided that neither party would be responsible for failure to perform "if and to the extent that fulfilment has been delayed or temporarily prevented by" a force majeure event. The list of events constituting force majeure included a drilling moratorium imposed by the government of Ghana.

The government imposed a drilling moratorium which affected certain of the oil fields in which the company had planned to use the rig. Drilling in other fields was also prevented, but not due to the moratorium – rather, it was because the government did not approve the development plan for those fields.

In the circumstances the court found that there were two effective causes of the company's failure to perform its obligations, only one of which (the moratorium) was a force majeure event. The force majeure event delayed or prevented the company providing a drilling programme for certain fields but not others. That was not sufficient.

The judge noted that this approach was consistent with the Court of Appeal's decision in *Intertradex v Lesieur* [1978] 2 Lloyd's Reports 509, which he said is regarded as establishing that a force majeure event must be the sole cause of the non-performance. Ultimately, however, the question is one of construction of the relevant contract.

In *Classic Maritime Inc v Limbungan Makmur SDN BHD* [2019] EWCA Civ 1102 (considered in this post on our Litigation Notes blog), the Court of Appeal considered a clause in a long-term contract for shipments of iron ore pellets. The clause provided that the charterer would not be responsible for failure to deliver cargo "resulting from" causes beyond the parties' control, provided they "directly affect the performance of either party".

The charterer failed to provide cargo for a number of shipments. The trial judge found that it was impossible for the charterer to provide cargo due to a dam burst at the relevant mine. However, if the dam burst had not occurred, the charterer would probably have defaulted anyway.

The Court of Appeal rejected the submission that there was a settled line of authority which established that, where a party relies on a force majeure clause, there is no need to prove "but for" causation. The question is not one of labels, but rather how the particular clause should be interpreted. Comments in the decision do, however, suggest that, in cases of uncertainty, the court may be less likely to find that there is a requirement for "but for" causation where the effect of the clause is to relieve a party of its future obligations, rather than excuse liability for past performance.

Here the court held there was a requirement to prove "but for" causation, including because of the need for the failure to "result from" a specified event which "directly affected" performance.

It is sometimes argued that, to come within a force majeure clause, an event must have been unforeseeable. In fact there is no general requirement under English law that an event must be unforeseeable to give rise to a claim for force majeure relief – subject of course to the terms of the clause. However, the more an event is foreseeable, the more it may be possible to guard against it having an impact on contractual performance, and so the more a failure to do so may be seen as the real cause of non-performance.

In *2 Entertain Video Ltd v Sony DADC Europe Ltd* [2020] EWHC 972 (TCC) (considered in this post), the High Court considered a clause in a contract to provide logistics and distribution services to the claimants, including storage of their stock at the defendant's warehouse. The warehouse was destroyed by fire during the 2011 London riots, and the court found that this was due to the defendant's negligence in failing to take reasonable security and fire safety measures.

The defendant sought to rely on a force majeure clause, which provided that neither party would be liable for its failure or delay in performing its obligations "if such failure or delay is caused by circumstances beyond the reasonable control of the party affected including but not limited to ... fire, ... riot [etc]".

The court held that the defendant could not rely on the clause. Although the riots were "unforeseen and unprecedented", the risk of arson was (or should have been) foreseen. If adequate measures had been taken, the attack on the warehouse would probably have been deterred or delayed and any damage significantly reduced. That meant that the fire and resulting losses were not outside the defendant's reasonable control, and so a force majeure defence was not available.

Notification and mitigation

A force majeure clause will ordinarily include obligations to notify the counterparty of the force majeure event. It will be important for a party wishing to rely on force majeure to comply with these obligations, as a failure to do so may mean that a defence of force majeure is not available. This will depend on whether the requirement to give notice, properly construed, is a condition precedent to reliance on the clause.

There may also be an obligation to notify the counterparty when the force majeure situation has come to an end and the affected party is able to resume performance.

A force majeure clause will also often include obligations to seek to mitigate the effects of the force majeure event. The clause may not be effective to prevent liability arising to the extent that the required efforts to mitigate have not been made. Even if there is no express obligation to mitigate, such an obligation may well be implied as a result of a requirement that the force majeure event is beyond the parties' reasonable control and/or a requirement that it prevents, hinders or delays performance. If the party could have avoided or mitigated the effects of the force majeure event, it may not be able to meet these requirements.

"Make sure you comply with any requirements to notify the counterparty of the force majeure event or mitigate its effects - otherwise you may find you can't rely on the clause"

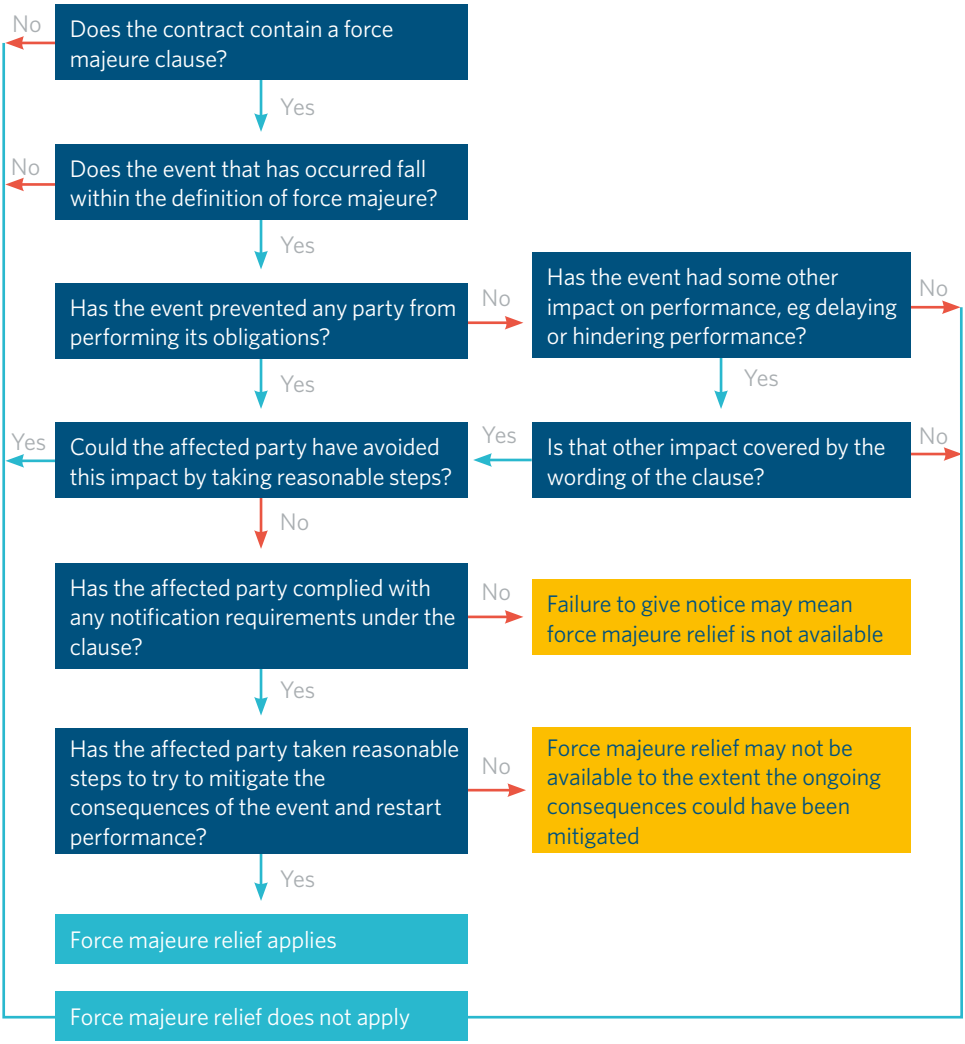
Effect of force majeure

The effect will vary depending on the specific terms of the clause. But, generally speaking, where a force majeure clause is successfully invoked, the parties' obligations under the contract are suspended without liability while the impact of the force majeure event continues.

Parties benefitting from force majeure relief should monitor the situation to ensure they are ready to resume performance as soon as the impact of the force majeure event has come to an end. A failure to do so could result in a party being in breach of contract.

Most force majeure clauses will also give a right to terminate the contract if the force majeure event continues for a specified period of time, which may be defined as a continuous period or alternatively as an aggregate number of days if there are multiple periods caused by the same force majeure event.

Is there a right to force majeure relief?



3. MAC clauses

A typical MAC clause will allow a party to refuse to proceed with a transaction if certain events occur after the contract date. They are most commonly found in the context of the sale of a company or business (allowing the buyer to walk away if there is a MAC before the deal closes) or a lending transaction (allowing the lender to call a default if there is a MAC affecting the borrower).

The drafting of MAC clauses varies greatly. They may be drafted widely, subject to specific carve-outs of events that will not qualify, or they may be drafted more narrowly to specify particular events that will qualify as a MAC. As with any contract term, the interpretation of a MAC clause will depend on the language used in the context of the contract as a whole, the background facts and the commercial context.

A MAC clause cannot be triggered on the basis of circumstances known to the relevant party on entering into the agreement, although it may be possible to invoke the clause where conditions worsen in a way that makes them materially different in nature. The change relied on must also be material, in the sense that it must be sufficiently significant or substantial, and it must not be merely a temporary blip.

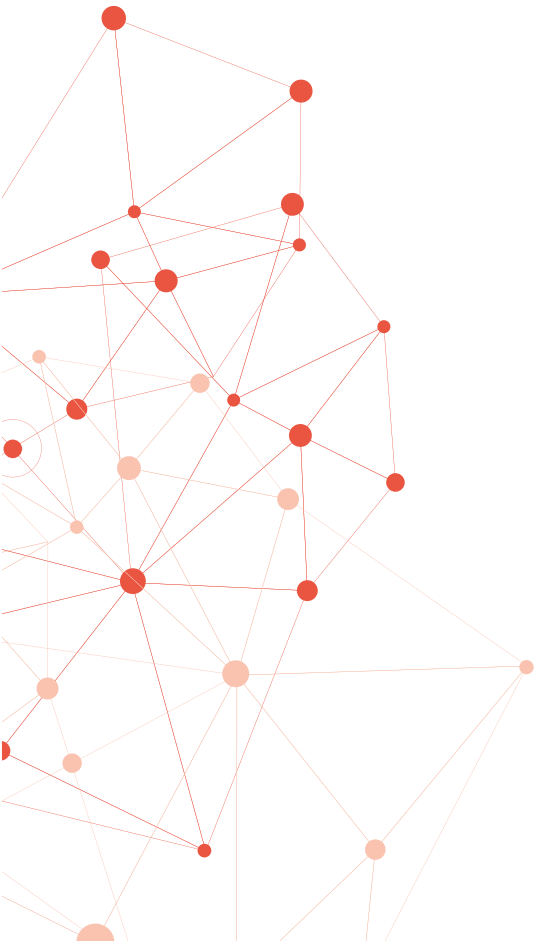
The party seeking to terminate the contract under a MAC clause has the burden of proving that a MAC has occurred.

In *Grupo Hotelero Urvasco SA v Carey Value Added SL* [2013] EWHC 1039 (Comm), the Commercial Court considered what it described as a MAC clause in simple form, the borrower representing that there had been no material adverse change in its financial condition since the date of the loan agreement. The lender argued that there had been a material adverse change since the agreement was entered into in December 2007, which meant it could withhold payment in June 2008.

The court summarised its approach to the clause: the assessment of the borrower's financial condition should begin with its financial information at the relevant times, but would not necessarily be limited to that information if the lender could show other compelling evidence. The adverse change would be material if it significantly affected the borrower's ability to repay the loan. However, the lender could not trigger the clause based on circumstances it was aware of at the time of the agreement.

On the facts, the court was satisfied that there was a material adverse change in the borrower's financial condition in the relevant period, in particular because it was only in 2008 that the full force of the bursting of the property bubble on the borrower's business became apparent.

"You may be able to invoke a MAC clause if events take an unexpected turn which has a dramatic impact in the circumstances of the transaction"



4. Frustration

The common law doctrine of frustration will apply where an event occurs after the contract has been entered into, which is not due to the fault of either party, and which renders further performance impossible or illegal, or makes the relevant obligations radically different from those contemplated by the parties at the time of contracting.

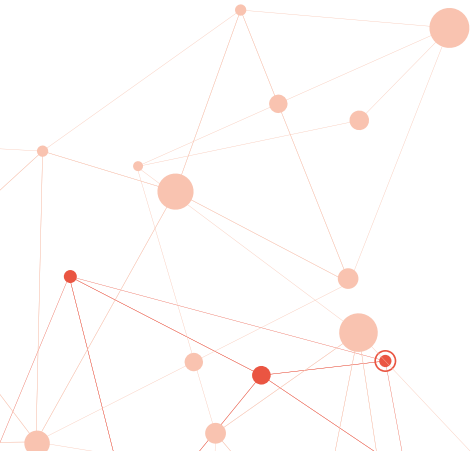
The courts have tended to apply the doctrine narrowly, emphasising that it is not lightly to be invoked to allow a contracting party to escape from what has turned out to be a bad bargain. In determining whether the doctrine applies, the court will consider multiple factors including the parties' knowledge and expectations at the time of contracting, as objectively ascertained. Events which make performance more onerous or more expensive will not necessarily be sufficient to frustrate the contract.

Grounds on which frustration has been argued in previous cases, and which could conceivably amount to frustration depending on the circumstances, include: epidemic or pandemic; a change in law or regulation; cancellation of an expected event; and serious delay.

The fact that an event is foreseeable will not necessarily preclude a finding of frustration, eg if an event such as a strike lasts so long as to render performance radically different from that contracted for. However, the less an event is foreseeable, the more likely it is to lead to frustration.

Where the contract expressly provides for the event which has occurred, the contract will not generally be frustrated – unless the event is significantly more dramatic than envisaged. (For example, the parties may include provisions relating to the possibility of a strike, but if a strike lasts so long as to mean that when the contract can eventually be performed it will be radically different from the performance contracted for, then the contract may be found to have been frustrated.) For this reason, the presence of a force majeure clause means frustration is less likely – though it is possible if the clause does not cover the event in question (eg if the list of force majeure events is narrowly and exhaustively defined).

"Frustration is rarely invoked successfully, but given the dramatic impact of the Covid-19 pandemic, there may be scope for the doctrine to apply in some cases – all will depend on the circumstances"



In *Edwinton Commercial v Tsavliris Russ* [2007] EWCA Civ 547 the Court of Appeal held that a 20 day time charter had not been frustrated by a delay of 108 days in redelivery of the vessel due to its detention by port authorities. The critical question was whether, at the relevant point, the existing and prospective delay would have led the parties to have reasonably concluded that the charter was frustrated.

Applying the doctrine of frustration required a "multi-factorial approach", taking into account for instance the terms of the contract, its context, the parties' (objectively determined) assumptions in particular as to risk, 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".

Here the court based its conclusion on a number of factors, including that the delay came at the very end of the charter, rather than interrupting "the heart of the adventure", and that the contractual risk of such delay was, in the court's view, firmly on the charterers. It was also relevant that the risk of detention was foreseeable, in general terms, even if the actual circumstances of the detention were unusual.

This conclusion was consistent with the dictates of justice, which provided a "reality check" as to the court's assessment of the issue of frustration.

In *Canary Wharf (BP4) T1 Ltd v European Medicines Agency* [2019] EWHC 335 (Ch) (considered in this post), the European Medicines Agency (EMA) argued that its lease of premises in Canary Wharf would be frustrated as a result of Brexit. Its primary case was that, as a matter of EU law, it would lack capacity to make use of the premises or perform its obligations under the lease. It argued in the alternative that there had been frustration of a common purpose, namely to use the premises to provide it with a permanent headquarters for the next 25 years.

The High Court rejected the EMA's case on both grounds. It found that the supervening event was in reality the EMA's involuntary departure from the premises, due to circumstances beyond its control. That involuntary departure was not merely envisaged but expressly provided for in the lease (which allowed assignment or sub-letting), and there was no common purpose outside of the lease. The EMA could not say this was not what it bargained for.

The judge noted that whether a contract is frustrated depends on a consideration of the nature of the parties' bargain when considered in the light of the supervening event said to frustrate that bargain. Only if the supervening event renders the performance of the bargain "radically different", when compared to the considerations in play at the conclusion of the contract, will the contract be frustrated.

The effect of frustration is to bring the contract to an end, immediately and automatically. It does not require an act by the parties to the contract.

The Law Reform (Frustrated Contracts) Act 1943 provides that sums paid (or payable) before the contract was frustrated are to be repaid (or cease to be payable). However, if the recipient incurred expenses before the frustrating event occurred, the court may allow it to retain (or recover) some or all of the relevant sums, up to the amount of those expenses, if the court "considers it just to do so having regard to all the circumstances of the case".

It is possible, however, to exclude the operation of these provisions by making separate provision for the consequences of frustration in the contract.

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