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COVID-19 – The Law Un-Masked: Non-performance of Commercial Contracts During the Coronavirus Pandemic

In our sixth article of the series "The Law Un-masked", **Tim Parker and Abigail Liu** take an in-depth look at the legal ramifications of the Coronavirus pandemic, in particular:

- The circumstances in which COVID-19 will trigger a force majeure clause

- When non-performance of a commercial contract due to COVID-19 may be excused under the doctrines of frustration and impossibility

Introduction

The rapid spread of COVID-19 has developed into a global threat. Alongside the enormous public health ramifications, the pandemic and the laws and regulations enacted to stem its spread are causing unprecedented disruption to businesses. Major challenges include interruption to supply chains, whole workforces in lockdown, and plummeting consumer demand. It is inevitable that some businesses will not be able to meet existing contractual obligations, or even to continue to operate at all.

This article addresses the way in which the Coronavirus pandemic will affect the continuing validity of contractual obligations. We set out the legal principles governing the circumstances in which contracting parties may be released from their obligations by the operation of a force majeure clause, or by invoking the common law doctrines of frustration and impossibility. The discussion inevitably addresses the general principles only, and as always, specific legal advice should be sought about the application of these principles to any particular contract.

What is a Force Majeure Clause?

A "force majeure clause" is a type of contractual term that is triggered by an exceptional event beyond the parties' control, and usually operates to excuse non-performance by one or more parties of their obligations under the contract where the event has prevented or hindered their fulfilling their end of the bargain. This will only apply if the contract includes such a term, since force majeure is not part of the general law of contract (although the related doctrines of frustration and impossibility may come to the aid of a non-performing party even if there is no such term – see below).

The term "force majeure" originates in French law and refers to a "superior force". There is no fixed list of the type of events that will constitute a force majeure. Whether or not COVID-19 will

amount to such an event turns entirely on the wording of the force majeure clause in the contract in question.[1]

Requirements for Invoking Force Majeure Clause

Where a contract contains a force majeure clause, the party seeking to invoke it will need to show that:

- COVID-19, and/or the governmental measures adopted in response to it, constitute events of force majeure within the meaning of the contract

- Performance of the relevant obligation was prevented, hindered or delayed (depending on what the contract says) by COVID-19 / the governmental measures

- In many cases, it will also be necessary for the party seeking to rely on the force majeure clause to show that they took reasonable steps to mitigate any losses arising out of their non-performance

We expand on each of these elements below.

Is COVID-19 an Event of Force Majeure?

This will be a critical question for many businesses, either in relation to their own obligations under a contract or those owed to them by the other party.

In analysing whether or not a given event constitutes a force majeure, it is necessary to begin by looking at the specific wording of the clause in the contract in question. Many force majeure clauses contain a list of force majeure events. Common examples include war, revolution or acts of terrorism.

If the clause in question includes wording such as "pandemic", "epidemic" or "disease" within the list of events of force majeure, it is likely that COVID-19 will qualify. Depending on the context, a reference to "plague" may potentially also cover COVID-19. The International Chamber of Commerce ("ICC") 2003 Force Majeure Clause, for example, specifically refers to "plague" and "epidemic" as force majeure events. If this term has been included (or incorporated by reference) in a commercial contract, it is very likely that COVID-19 will constitute a force majeure event.

Some clauses may contain a general category, for example: "all events outside the reasonable control of the parties". Although each contract has to be interpreted on its own terms, including as to whether certain risks have been assigned to the parties under the contract, it is likely that

[1] *Thomas Borthwick (Glasgow) Ltd v Faure Fairclough Ltd* [1968] 1 Lloyd's Rep 16.

COVID-19 will fall within a general force majeure clause of this nature. COVID-19 is an event that is beyond the parties' control and thus likely to fall within a widely drafted clause like this. It is also an event that is of the type that would likely have been within the contemplation of reasonable parties agreeing to a general clause of this nature.

Another commonly used term is "acts of god". An act of god refers to the operation of natural forces (as opposed to acts of man) not reasonably possible to foresee and guard against.[2] Whether COVID-19 will be caught by this phrase is debatable. There are authorities suggesting that a disease that is not self-inflicted may constitute an act of god.[3] A note of caution should be sounded here. While the emergence of a disease itself may arguably be an unforeseeable natural disaster, it may be argued that its spread between humans involves human agency and is not *per se* an act of god. It might also be contended that any disturbance caused to businesses by regulatory government measures adopted in response to the outbreak of COVID-19 is not caused by an act of god even if the disease itself meets the definition.

Governmental Acts in Response to COVID-19

Many force majeure clauses will be triggered where performance is inhibited by "government orders", "government action" or "government acts or priorities" (the first two of which appear in the ICC Force Majeure Clause). Such terms are likely to be relevant in the context of COVID-19, given the highly restrictive governmental measures adopted in response to it.

The HKSAR Government has promulgated two sets of Regulations which, among other things, severely restrict public gatherings, require places of entertainment to cease business, and limit capacity at restaurants.[4] The scope of these new regulations has been discussed in another article in this series: see COVID-19 – The Law Unmasked: A New Cluster of Regulations: An Overview on Compliance and Enforcement Powers for Businesses and Gatherings. These have been followed up by further measures ordering the closure of pubs and bars. Such Regulations are likely to constitute "government orders" or "government acts", or other similar phrases used in force majeure clauses. As are the Government-imposed quarantine of incoming travelers, infected persons and their close contacts.

Required Impact of the Force Majeure Event on Performance

The fact that an event of force majeure has arisen does not of itself excuse performance of a contract. There must be a causal relationship between the force majeure event and the non-

[2] Chitty on Contracts 33rd Ed.§36-019.
[3] See *Boast v Firth* [1868-69] LR 4 CP 1, *Isabella Hall v George Wright* (1859) 120 ER 695, *Ryan v Youngs* [1938] 1 All ER 522.
[4] See the Prevention and Control of Disease (Requirements and Directions) (Business and Premises) Regulation, Cap. 599F, and the Prevention and Control of Disease (Prohibition on Group Gathering) Regulation, Cap. 599G (the "**Regulations**").

performance. Precisely what is required by way of causation turns on the wording of the contract. The contract may require, for example, that the force majeure event has "prevented" performance,[5] or "rendered [the party] unable" to carry out its obligations.[6]

Other contracts may stipulate that the event need only have "hindered",[7] or "delayed"[8] performance of the relevant obligation.

"Prevented" sets the highest causative hurdle. Where this word is used, the party seeking to rely on the force majeure clause must show that performance has become physically or legally impossible – as opposed to merely more difficult, more expensive or less profitable.[9]

If the force majeure clause provides relief where performance is "hindered" or "delayed", this is a significantly less stringent standard. The benefit of the clause may be available when the event of force majeure renders performance substantially more difficult and financially burdensome.[10] As the Court of Final Appeal held in the leading case of *Goldlion Properties Ltd and Others v Regent National Enterprises Ltd*[11], where the words "materially hindered" were used, there was no requirement for the party invoking the force majeure clause to prove that "completion had been prevented or become impossible".[12]

As a matter of legal policy, the Courts will not lightly conclude that non-performance is excused by an event of force majeure. The mere fact that the market or economic situation attendant on a force majeure event has made performance of the contract more onerous or difficult, or less profitable, will not excuse a party from fulfilling it. Parties are taken to contract on the basis that, within reasonably foreseeable limits, the risk that more resources may have to be allocated to perform the bargain than those originally contemplated – and thus diminishing one party's profits – is part and parcel of doing business.

Duty to Mitigate

There is no general duty to mitigate the effects of a force majeure event[13] (although the position appears to be otherwise in England[14]). In practice, however, many force majeure clauses impose such a requirement.

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[5] *Tennants (Lancashire) Ltd v CS Wilson & Co Ltd* [1917] AC 495.
[6] *Thames Valley Power v. Total Gas & Power* [2005] EWHC 2208 (Comm).
[7] *Peter Dixon & Sons Ltd v Henderson, Craig & Co Ltd* [1919] 2 KB 778.
[8] *Ibid.*
[9] *Thames Valley Power v. Total Gas & Power* [2005] EWHC 2208 (Comm).
[10] *Peter Dixon & Sons Ltd v Henderson, Craig & Co Ltd* [1919] 2 KB 778.
[11] (2009) 12 HKCFAR 512.
[12] *Ibid.* at 540A.
[13] *Ibid.* at 543G-H.
[14] *Channel Island Ferries Ltd v Sealink UK Ltd* [1988] 1 Lloyd's Rep 323.

Where the term does require mitigation, it will be incumbent on the non-performing party to try to avoid as far as possible the adverse consequences of the event of force majeure and minimise the losses it causes. In the present context, such a term would place the onus on the party seeking to invoke the clause to prove that it had taken reasonable precautions and measures to minimise the impact of COVID-19 on the performance of the relevant obligation(s), and the damage that will do. The failure to do so may mean that the force majeure clause cannot be relied upon.

Relief Conferred by a Force Majeure Clause

Where a party is able to rely on a force majeure clause, the relief that flows depends entirely on what has been specified in the contract. Common formulations include the following:

- that certain obligations under the agreement will be suspended for a given period of time – usually until the relevant event ceases to prevent or hinder (etc.) performance

- that one or both parties is entitled to terminate the contract

- that the contract is suspended for a period of time, after which it can be formally terminated

A force majeure clause will almost invariably provide a defence for the non-performing party in the event they are sued for a breach which has been precipitated by the event of force majeure.

Points to Note before Invoking Force Majeure Clauses

Apart from mitigation (see above), care must also be taken to comply with any procedural requirements detailed in the contract prior to halting performance. For example, many contracts will require a party wishing to rely on a force majeure clause to give formal notice of this, and may impose a time limit within which such notice must be given. Close attention should be paid to the form and contents of any notice that must be given (e.g. many contracts stipulate that any notice must be given by a particular means, such as by post). Other contracts may require a disputes procedure to be exhausted prior to any termination.

Depending on the wording of the relevant clause, such procedural requirements may be interpreted to be pre-conditions to a valid exercise of the right, and if not complied with, the right to invoke the force majeure clause may be lost. This is particularly so where one is seeking to terminate the contract.[15]

[15] See e.g. *Tradax Export SA v Andre & Cie SA* [1976] 1 Lloyd's Rep 416. But compare *Bremer Handelgesellschaft v Vanden Avenne-Izegem PVBA* [1978] 2 Lloyd's Rep 109.

Accordingly, any procedural requirements should be strictly complied with in form and substance. Moreover, parties wishing to terminate should generally do so reasonably promptly to avoid any suggestion that they have sat on or waived their rights.

Material Adverse Change Provision

Some contracts will provide a party the right to terminate in the event of a "material adverse change". Such terms are relatively common in acquisition and merger deals, and some complex financial instruments.

As with a force majeure clause, whether or not a change arising out of COVID-19 is of the type which will trigger the clause, and whether its impact sufficiently material, is a question of interpretation of the provision in issue.[16]

Grounds for Termination at Common Law – Frustration and Impossibility

Frustration and impossibility (which for convenience we refer to collectively as frustration) apply where events outside the control of the parties render performance of the contract legally, physically or commercially impossible, or transform the obligations under it into something radically different from what was contracted for.[17] This is a high threshold: it is necessary to show more than mere inconvenience, hardship or reduced profitability.

In *Li Ching Wing v Xuan Yi Xiong*[18], Judge Lok considered the application of the doctrine of frustration in the 2003 SARS outbreak in Hong Kong. The parties had signed a two-year tenancy agreement. An isolation order, lasting for 10 days, was imposed over the building after a number of residents contracted SARS. The plaintiff purported to terminate the lease after the 10-day isolation order came to an end on the ground of frustration (among other grounds). Judge Lok held that the 10-day isolation period was insignificant in the context of whole term of the lease, and decided that although the outbreak of SARS may arguably have been an unforeseeable event, *"such supervening event did not … significantly change the nature of the outstanding contractual rights and obligations from what the parties could reasonably have contemplated at the time of the execution of the Tenancy Agreement"*.[19]

Frustration will apply where performance of the whole contract has become illegal. This is likely to be highly relevant in the context of COVD-19, given the Regulations introduced by the HKSAR Government (mentioned above) which restrict many activities previously taken for granted. For

[16] See e.g. *Grupo Hotelero Urvasco SA v Carey Value Added SL and Another* [2013] EWHC 1039 (Comm); *Cukurova Finance International Limited and another v Alfa Telecom Turkey Limited* [2013] UKPC 2.
[17] *Davis Contractor Ltd v Fareham Urban District Council* [1956] A.C. 696; *Tsakiroglou & Co Ltd v Noblee Thorl GmbH* [1962] AC 93.
[18] [2004] 1 HKLRD 754.
[19] [2004] 1 HKLRD 754 at 758J.

example, a contract with a concert venue to hold a large concert will, while the Regulations banning gatherings remain in force, likely be held frustrated by supervening illegality. If performance becomes unlawful only in part, it is a question of fact and degree whether the whole contract should be treated as frustrated.

Relationship between Force Majeure and Frustration

The presence of a force majeure clause in a given contract may preclude the operation of the doctrine of frustration. The logic is this: the doctrine of frustration is concerned with supervening events unforeseen at the time of the entry of the contract. If the contract contains express provisions that cater for the event in question, e.g. a force majeure clause that covers the outbreak of COVID-19, the doctrine of frustration would not be lightly invoked as an event of that nature has been foreseen and the risks allocated.[20] So where there is an express term *"which is intended to and does deal fully and completely with the effects of an event which would otherwise, absent the clause, frustrate the contract"*, the doctrine of frustration does not apply.[21]

Whether a given force majeure clause excludes the possibility of relying on frustration entirely has been described by the Courts as a "*difficult*" question that turns on the specific wording of the clause and the implicit assumptions of the parties about the allocation and assumption of risk under the terms of the contract.[22]

Consequences of Invoking the Doctrine of Frustration

Frustration brings an end to the contract automatically and all parties will be released from their obligations. At common law, the Court has no power to allow the contract to continue or to modify its terms.

The Courts have various powers under section 16 of the Law Amendment and Reform (Consolidation) Ordinance (Cap. 23) to give relief where a contract is discharged for frustration. For example, the court may order that the purchase price be returned, or that a party be compensated for expenses incurred before the contract was frustrated.

Deciding to Terminate a Contract – and Considering Alternatives

An unanticipated, catastrophic event such as the Coronavirus outbreak will inevitably lead to the termination of many commercial contracts, whether under force majeure clauses, other terminations provisions, or following breach by one of the parties. Great care should be taken when deciding to terminate a contract. Serving a notice of termination in circumstances where

[20] *Bank Line Ltd v Arthur Capel & Co* [1919] AC 435 at 459.
[21] *Select Commodities Ltd v Valdo SA* [2007] 1 Lloyd's Rep 1.
[22] *Edwinton Commercial Corp v Tsavliris Russ (Worldwide Salvage & Towage) Ltd* [2007] 2 Lloyd's Rep 517.

grounds for termination are not objectively made out may, in certain circumstances, be treated by the other party as a repudiatory breach of contract – entitling them to terminate and claim damages.[23]

Other options should always be considered, such as renegotiation or terminating the agreement by mutual consent, which can reduce or eliminate the risks of wrongful termination.

The application of principles relating to force majeure and frustration is highly fact-sensitive and requires careful analysis. If in doubt, it is wise to approach your legal advisors early in the process.

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[23] *Regulus Ship Services Pte Ltd v Lundin Services BV* [2016] EWHC 2674. Contrast this case with *Woodar Investment Development Ltd v Wimpey Construction UK Ltd* [1980] 1 WLR 277 (HL), and *Eminence Property Developments Ltd v Heaney* [2010] EWCA Civ 1168.

Disclaimer: This article does not constitute as legal advice and seeks to set out the general principles of the law. Detailed advice should therefore be sought from a legal professional relating to the individual merits and facts of a particular case.