Hogan Lovells

COVID-19: a checklist for dealing with contractual default and renegotiation

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COVID-19 is likely to have a significant impact on the (non-)performance of commercial contracts across all sectors. This note provides a high-level checklist of some of the key issues to consider when dealing with an actual or anticipated default of an English law contract, particularly if you want to protect your legal position in the event of a future dispute while seeking to negotiate a variation or settlement.

1. Preserve legal professional privilege where necessary

- Documents that are not privileged may need to be disclosed to the other side in a later dispute. Therefore, think about privilege before you send any written communications or create any other documents about a default and before you seek or provide any legal advice.

- Unless litigation is reasonably in prospect, only communications between a lawyer and client are likely to be protected from disclosure in the event of future litigation. You will need to bear this in mind and draft other documents on the basis that they may be disclosable in any future dispute.

- To protect privilege in relevant documents, follow these rules of the road from the start:

  – Prepare and maintain a list of employees who are authorised to seek legal advice (the "client team"). Limit communications with lawyers (internal and external) to this client team.

  – Keep legal and commercial communications separate. A document is only protected if its dominant purpose is the giving or receiving of legal advice.

  – Mark all privileged communications as privileged, confidential and not for onward transmission. This does not make a document privileged but can be helpful evidence.

  - Maintain confidentiality. Do not share privileged communications outside the client team unless absolutely necessary and only after obtaining a confidentiality undertaking. Always consult a lawyer before doing so.
  - Circulate communications guidance to all relevant employees. Ensure that everyone drafts non-privileged documents in a factual and neutral way, such that you would be comfortable with a third party seeing them.

- If at any point you consider (or are advised) that litigation is reasonably in prospect, record that with reasons in a document that you would be prepared to disclose. Consult a lawyer as to the scope of any litigation privilege going forward.

2. Understand the contractual position

- Identify the relevant clauses in the contract(s). They are likely to include some or all of the following.

2.1 Governing law and jurisdiction

- Governing law should be your starting point, as it determines how the contract will be interpreted. If English law governs, the words used in the contract will be key. If a different law governs, take local law advice on all of the issues in this note.

- Jurisdiction determines which court or tribunal would ultimately hear any dispute, but it can also be relevant to interim relief. Consider whether the jurisdiction clause is equal or one-sided and whether either party has a choice of forum. Consult local lawyers as appropriate.

- If your transaction or relationship is governed by a series of contracts, review each one individually. They might not all have the same provisions, in which case conflicts of laws issues can arise.

2.2 Performance obligation(s) and consequences of default

- Identify the performance obligation(s) in respect of which there has been, or is expected to be, a default. Consider the seriousness of the breach including whether it is likely to be fundamental enough to be repudiatory and give rise to a right to terminate.

- Assess whether the contract anticipates this default situation. For example, it might contain:
  - notice requirements;
  - (non-)waiver provisions;
  - grace periods and remedial steps;

  - contractual rights and remedies, such as an increased rate of interest, a right of set-off, a right to enforce security, a right to obtain substitute performance from an alternative source, a right to terminate; and/or
  - a procedure for resolving a dispute.

- Whether you are the defaulting or non-defaulting party, ensure that you comply with the relevant contractual requirements in good time. Unlike some other jurisdictions, failure to comply with notice provisions may time-bar the claim (depending on the drafting of those provisions).

2.3 Force majeure

- Under English law, force majeure can only excuse non-performance if this is expressly provided in the contract. A force majeure clause is not always obvious. It might refer to "exceptions", "unforeseen circumstances" or an "act of God".

- If there is a force majeure clause, assess whether the COVID-19 pandemic comes within scope, and whether (as a matter of fact) that is preventing performance. If so, consider what consequences the contract prescribes, such as suspension of performance or termination.

- See our separate checklist on force majeure for more detail: "Coronavirus as a contractual force majeure event: a simple checklist".

2.4 Material adverse change

- A material adverse change or "MAC" clause (also known as a “material adverse effect” or "MAE" clause) tries to protect one party from certain changes in or to another party. When triggered, a MAC clause will typically allow the protected party to withdraw from the transaction as originally contemplated or exercise certain remedies under the agreement.

- MAC clauses are common in English law finance agreements. If your contract has a MAC clause, consider whether it has been triggered and, if so, whether it allows the protected party to withdraw from the transaction as contemplated or accelerate any loan facility and/or enforce security.

- Please contact us if you would like to see our detailed analysis on MAC clauses and the COVID-19 pandemic.

2.5 Change in Law and other provisions

- Consider whether there are other contractual provisions - such as Change in Law clauses - that may have been triggered in response to the COVID-19 pandemic and which may bring relief to the affected party (they may, unlike force majeure, also bring an entitlement to recover additional costs as well as extending the time for performance).

3. Identify other relevant legal principles

- Consider whether there are any other applicable legal principles beyond the express terms of the contract. They might include:
  - Mitigation: if you have suffered or will suffer a loss, you are likely to be under a duty to mitigate that loss. Consider what steps you can reasonably take to discharge this duty and ensure you can recover your remaining losses. (Depending on the precise contract terms, the affected party may also be under a duty to mitigate the impact of (for example) force majeure.)
  - Frustration: consider whether the contract could be frustrated on the basis that performance has been rendered impossible.

4. Preserve your legal rights and remedies

- While you are considering your options, in addition to complying with any contractual requirements, think about what else you can do to protect your position and/or preserve your rights and remedies. For example:
  - If you are the defaulting party, consider preparing a factual record of the difficulties you have encountered in rendering performance. Draft it in a way that you would be comfortable with a third party seeing, as it could be relevant evidence in the event of a dispute.
  - If you are the non-defaulting party, consider sending a reservation of rights letter if you do not intend to act on the default immediately. Depending on the terms of the contract and the nature of the default, you might include statements that:
    - the default has occurred;
    - the default has not been waived by you;
    - the default can only be waived in writing;
    - no action, inaction or delay by you should be construed as a waiver of the default or of any right or remedy; and
    - all of your rights and remedies under the contract and in law are fully reserved,

    in each case referring to any relevant contractual provisions. You should also consider whether there are any applicable notice requirements.
- Consider whether you have incurred costs that are recoverable from your counterparty and, if so, send a notice demanding payment.

- Consider whether you can and should apply for interim relief (for example, an injunction or a preservation order), and in which jurisdiction(s). Take local law advice as necessary.

5. Protect your legal position in negotiations

- If you are the non-defaulting party but want to avoid a dispute, your options are likely to include waiving the default, renegotiating the contract, terminating the contract, and reaching a settlement (or a hybrid of these options).

- If you want to seek a renegotiation or settlement, bear in mind the following.

5.1 Protect communications with your counterparty

- Ensure that all oral and written communications with your counterparty aimed at negotiating a variation or settlement are expressed to be without prejudice and subject to contract. Communications genuinely aimed at resolving a dispute cannot be used as evidence in future litigation.

- In particular:

  – Clearly label emails and other written communications "without prejudice". Agree at the beginning of any meeting or telephone call that the discussion is on a "without prejudice" basis and record that in any written note of the call/meeting.

  – Clearly label any written proposals that you make to your counterparty, including heads of terms and draft agreements (and comments on the same), "subject to contract" or "without prejudice and subject to contract". Likewise, make clear that any proposals made orally are on this basis.

  – Make contemporaneous notes of any important oral discussions and ensure they are also appropriately labelled.

5.2 Consider any insolvency risk

- If you are the non-defaulting party, consider whether your counterparty's default might be a sign of impending insolvency. If so, then this will likely influence the terms on which you are prepared to renegotiate or settle. Dealing with insolvency practitioners adds complexity and if this is a concern you should take legal advice.

- Take local legal advice if the defaulting party could declare insolvency in a jurisdiction you are not familiar with to ensure you understand the effect of local rules relating to moratoriums etc.

5.3 Document the settlement or agreed amendments carefully and formally

- Negotiate terms carefully and ensure they are acceptable. For example:

  - If you are the defaulting party, be confident that you can comply with your new obligations. Given the highly uncertain future path of the COVID-19 pandemic, beware of committing to renegotiated terms and/or mitigation plans that expose you to still-greater liability in the event you are unable to perform.

  - If you are the non-defaulting party, make sure that you preserve your rights and remedies and/or receive appropriate consideration (and perhaps security for future payments) for any releases and waivers.

- Document the agreed terms formally and thoroughly. Do not rely on an oral or skeletal agreement.

- If you are renegotiating the terms of the contract, consider whether a new agreement is required or whether the existing one can be varied, and comply with any prescribed formalities.

- If you are resolving the matter by way of a settlement:

  - Decide whether the agreement is in full and final settlement of any present or future claims connected to the default. If you are the defaulting party, you will want this and the associated releases to be as widely drafted as possible.

  - Consider the extent to which you want the settlement to be confidential and include appropriate carve outs (for example, providing the agreement to your auditors, lawyers or other group companies).

  - Choose your governing law and jurisdiction carefully to ensure that any disputes which arise out of the settlement can be resolved in an appropriate manner.

  - Ensure you include service of process provisions and obtain necessary authorities in the usual way.

6. Identify and implement lessons learned

- Think about whether other existing or future contracts should be revised to address any difficulties encountered and associated learning points. Options include: prescribing the consequences of a default; expanding or refining the scope of force majeure clauses; and amending governing law and jurisdiction provisions.

- If you are amending other agreements at the moment, try to carry over any lessons learned from the COVID-19 pandemic. Take appropriate action such as considering whether COVID-19 or its recurrence may now be considered a 'foreseeable' event and whether contract terms such as force majeure should be amended accordingly.

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