COVID-19 – Issues Affecting Performance Of Contractual Obligations In Construction Contracts Governed By English Law

The COVID-19 crisis has set in train a cascade of events that will impede, delay or prevent performance of many contracts in the coming months. Businesses are likely to face pressure from many directions: shortages of materials, shortages of staff, limitations on movement of personnel, restrictions on conducting operations, other legislative and administrative actions, and the insolvency of contractors, subcontractors and suppliers, to give only what is ultimately likely to be a limited set of examples. Through no fault of their own, many will find themselves in a position where it is impractical to perform some or all of their contractual obligations and where they will be forced to seek, by whatever means they can, temporary or permanent relief from performance.

I. Background

In general, four possible strategies are likely to be available:

- Renegotiate the terms of the contract, including by requesting waivers of contractual conditions and obligations.

- Invoke any force majeure clause in the contract and, depending on its terms, suspend or abandon further performance.

- Assert that the contract has been frustrated and, on that basis, abandon further performance altogether (and likewise release the counterparty from further performance).

- If legislative or administrative interference prevents the performance of specific terms, invoke the doctrine of severance to (in effect) delete the offending terms and preserve the rest of the contract.

In the case of merger and acquisition agreements and finance agreements, many of which contain material adverse change (or material adverse effect) clauses, such clauses may also provide a basis for drastic action in accordance with the contract, such as (for example) termination of a deal or the acceleration of loans.

Each strategy raises legal risks, which are addressed in detail below. However, some general observations may be made:

- Broadly speaking, the first option – if realistic in practice – carries the least legal risks (and often produces the best commercial outcome). However, parties seeking waivers or amendments should be aware of the need to ensure that any agreed changes can be evidenced if there is a subsequent dispute. They should also comply with any contractual conditions to amendments or waivers. Both should be (relatively) straightforward to achieve.

- The next two options, particularly relying upon the doctrine of frustration, are more drastic, and considerably riskier. The gravest risk they pose is that, by indicating that a desire to limit the extent of its further performance, a party will inadvertently repudiate the contract. The financial consequences of this may be extreme. If the counterparty accepts the repudiation as discharging the contract, the default result is that the first party will be liable to put the counterparty in the position it would have been had the contract been performed (subject to the application of any relevant limitation or exclusion clause). The financial compensation which would then be payable could be very substantial.

- Asserting that specific terms of the contract have been severed from it offers a party an opportunity to preserve the deal but on potentially better terms. Severance operates to excise a clause (or part of a clause) from a contract where whose performance of the clause (or relevant part thereof) has become illegal. While it is difficult to difficult to establish all of the requisite elements of a severance claim, it may in certain circumstances offer a party a less risky means of escaping performance (or impossible performance) of an obligation as opposed to relying upon the doctrine of frustration or a force majeure clause.

- Where available, relying on a MAC clause may appear to be a safe ground for exiting an agreement which has been negatively impacted by the spread of the coronavirus. However, whether there has been an adverse change which is material is ultimately a subjective question, and, if it has to be made by a court, will (in practical terms) be considered with the benefit of hindsight. Parties may therefore face uncertainty as to whether reliance upon a MAC clause will be upheld by a court.

Businesses may also find themselves in a position where they are reacting to actions taken by contractors. They may have to:

- Anticipate and respond to any decision by a counterparty to renegotiate the contract or seek to claim relief from performance.

- If the counterparty suspends or ceases performance, or indicates that it will be doing so, consider whether that amounts to repudiation of the contract, and (if so) elect whether to insist on performance or terminate the contract and claim damages.

The risks arising from repudiation fall overwhelmingly on the party seeking to exit a contract, so the possible occurrence of a repudiation could provide grounds for an opportunistic counterparty to initiate a renegotiation or settlement in its favour.

II. Varying or Amending Contracts

The impact of the spread of COVID-19 will inevitably result in some parties agreeing to amend their contracts, e.g. in terms of scope, dates for performance or potentially, both. A variation or amendment to an existing contract is itself a contract, and English common law generally imposes no *formal* requirements for the validity of a simple contract. English common law does impose certain *substantive* requirements, such as the rule that a promise must be supported by consideration in order

to be enforceable. As a result of the general absence of formal requirements in English law, parties have great flexibility and can easily enter into, or vary, contracts.

However, many contracts contain "No Oral Modification" clauses, which require variations to be agreed in writing. Recently, the UK Supreme Court held that such clauses are legally effective: *Rock Advertising Ltd v MWB Business Exchange Centres Ltd.*[1] Amendments that do not comply with the conditions imposed by such a clause are not effective.

In some circumstances, "No Oral Modification" clauses could lead to injustice. For example, what happens if an oral modification is agreed (despite such a clause) and a party performs the contract as modified? In English law, the safeguard against this sort of injustice is the doctrine of estoppel, which may prevent a party from relying on a No Oral Modification clause. However, in *Rock Advertising Ltd v MWB Business Exchange Centres Ltd*, the UK Supreme Court indicated that, in order to preclude reliance on such a clause, at the very least (i) there would have to be some words or conduct unequivocally representing that the variation was valid notwithstanding its informality; and (ii) something more would be required for this purpose over and above the informal promise itself. Accordingly, in practical terms, the doctrine of estoppel will often not be available to a party seeking to avoid the effect of a No Oral Modification clause.

Accordingly, while it may appear to be a trivial matter, compliance with all contractual conditions to amending a contract is essential.

If what is being sought is not an amendment to a contract but a waiver of a contractual requirement (e.g. that delivery by a particular date will not be insisted upon), the same principles apply. Many contracts contain provisions stating that a failure to exercise a right does not amount to a waiver of the right unless it is confirmed in writing (often referred to as a "No Waiver" provision). Such provisions are enforceable, and a party seeking a waiver should also ask its counterparty to confirm the waiver in writing. Parties which are asked to grant waivers but choose not to do so should also be aware that the courts have held that it is possible to waive reliance upon a No Waiver provision: *ZVI Construction Co LLC v The University of Notre Dame (USA) in England*.[2] This has the potential to hinder commercial discussions where a contractual obligation has not been met and a waiver is being considered. When is the party which has been asked to grant the waiver to be taken to have waived its reliance upon a No Waiver provision? Unfortunately, the cases offer little practical guidance on this point.

III. Force Majeure Clauses and Frustration – Different Responses to the Same Problem

The common law doctrine of frustration and "force majeure clauses" are different responses to the same question: when should a contracting party which, through no fault of its own, can no longer perform its obligations be relieved of the obligations or of liability for not performing them?

[1] [2018] UKSC 24.
[2] [2016] EWHC 1924 (TCC).

In general, parties to a contract are likely to be more satisfied by the answers given by their force majeure clauses than by the doctrine of frustration. The latter is an unwieldy, and unpredictable, instrument of the law. In general, and as detailed further below, it is exceptionally challenging to show that a frustrating event has occurred. Even if that hurdle is overcome, the effects of the application of the doctrine of frustration are drastic. They are also rarely fair or commercially satisfactory to either party.

By contrast, force majeure clauses are likely to offer considered and commercially realistic solutions to the problem of impeded performance. They also generally set a lower threshold to the availability of relief. As to their effects, they tend, depending on their terms, to be more predictable and to achieve a more proportionate and sophisticated allocation of the losses resulting from the supervening event, which is in both parties' interests. Parties should therefore generally look to their force majeure clauses before considering invoking the doctrine of frustration.

IV. Force Majeure Clauses

Introduction

"Force majeure" (literally, "greater force") is not a term of art in English law, and it has no particular significance in common law systems.[3] Rather, it is a label used to describe exceptional events that commercial contracts commonly identify as entitling affected parties to escape liability for non-performance. The clauses specifying the relevant events and the required effect on the parties' obligations are known as "force majeure clauses".

As it is a creature of agreement and not of any overarching legal principle, the effect of a force majeure clause depends entirely on the terms in which it is drafted and the commercial background to and context of the contract in which it appears. However, drafting practices have converged over time, and most force majeure clauses require a similar set of conditions to be met before relief can be claimed. While each clause must be considered on its own terms, generally, such clauses require the party invoking them to prove four things:

- The occurrence of an exceptional event – the relevant "force majeure". The precise nature of the event can vary broadly. In construction contracts (with the exception of the JCT suite of contracts), a broad concept of force majeure mostly prevails. Relevant events are generally defined by their effect on performance rather than their nature. However, it is common in other contexts to find a more prescriptive approach, in which (for instance) force majeure is limited to industrial action, military conflicts or natural disasters such as earthquakes.

- That the force majeure event has impeded a party's ability to perform to the necessary degree. The precise degree of interference required varies according to the wording of the clause. For instance, many contracts stipulate that the force majeure event must "prevent" performance,[4]

[3] The term originates in the French Civil Code, which through various iterations has treated "force majeure" as a defence to a claim for damages for breach of contract.
[4] For an overview of such clauses, see Chitty on Contracts 33rd Ed. at 15-156-157.

whereas others require no more than "hindrance" or "delay".[5] Such distinctions matter in practice. An embargo of ports in a country affected by the coronavirus could, by way of example, affect a contractor's obligation to deliver materials very differently depending on which standard applies. If the relevant obligation is simply the delivery of materials and the applicable contractual regime requires prevention as a condition to relief, the contractor would be unlikely, on the face of the contract, to be able to claim force majeure as other methods of delivering the materials would be likely to be available. Instead, the contractor would generally be required to restructure its supply chain to source the materials from elsewhere (potentially at great costs).[6] By contrast, a force majeure clause subject only to a "hindrance" condition might more readily enable a supplier to suspend its obligations entirely, avoiding major financial damage, in the same circumstances.

- A sufficiently close causal relationship between the force majeure event and the impediment to performance. An unexpected event is not sufficient – the force majeure event must impede performance. Surprisingly, this is often overlooked in the drafting of force majeure notices and reliance upon force majeure clauses. The necessary causal proximity between the force majeure event and the impeded performance will vary according to the terms of the force majeure clause. An affected party may have to prove that the event of force majeure is the operative cause of the impediment. Alternatively, it may be enough for the event merely to have contributed substantially to the occurrence of the event, such that while it is among the *concurrent* causes, the non-performance might have occurred without it. Commentators have traditionally considered the latter to be the default position in the absence of words to the contrary,[7] but recent case law casts doubt on this.[8] While the question remains open, and its answer will in each case (as ever) depend on the detail of the clause, it would be consistent with the judicial tendencies to interpret force majeure clauses restrictively for a party seeking to rely upon force majeure to be required to demonstrate that it would have been willing and able to perform the contract "but for" the force majeure event. This is a high standard. Bearing in mind that these matters will be judged with hindsight, parties seeking to rely upon force majeure provisions should consider keeping detailed contemporaneous records of steps taken to investigate and consider alternative means of performance.

[5] These provisions are briefly considered at 15-158 and 15-158 respectively of Chitty on Contracts 33rd Ed.

[6] However, the wider factual matrix concerning the contract might be relevant. For example, if it was self-evident to the parties, when they entered into the contract, that the materials in question would always need to be imported by ship, an argument that delivery has been prevented may be available.

[7] *Bremer Handelsgesell-schaft v Vanden Avenne* [1978] 2 Lloyd's Report 109; *Bremer Handelsgesellschaft v Westzucker* [1981] 2 Lloyd's Reports 130. See also Chitty on Contracts, 33rd Ed. 15-156. The level of causal proximity required may turn on whether the force majeure is drafted so as to operate as an exemption clause, relieving a party from the consequences of breach, or whether it prevents a breach from occurring in the first place (the approach adopted in many standard form construction contracts). Arguably, on the latter approach, there is no need to show that Force Majeure is the sole operative cause of prevention. As always, the position will ultimately depend on a detailed investigation of the specific terms of the clause and the commercial context in which it operates.

[8] *Classic Maritime Inc v Limbungan Makmur SDN BHD* [2019] EWCA Civ 1102.

- That the occurrence of the event and its effect on performance were beyond the party's control.[9] This generally means that the event must have been unforeseeable and beyond the control of the parties (at the time of the event).[10] As to the former, if the event was sufficiently predictable to enable a sensible contractor to take precautions in place at the time of agreement, that will generally prevent the clause from operating. As to the latter, if the affected party can reasonably be expected to take sufficient measures to preserve its ability to perform notwithstanding the event, it will not usually be permitted to rely on the force majeure clause.

The English courts traditionally interpret force majeure clauses restrictively,[11] and the burden of proof is on the party seeking to rely on the clause.[12] While these conventions may come under pressure as the coronavirus cases play out in the courts,[13] engaging a force majeure always requires particularly careful factual investigation and contractual analysis. It is not to be done lightly, particularly as the consequence of an invalid reliance upon a force majeure clause may amount to a repudiation of the agreement.

Where a particular event is clearly within the scope of a force majeure clause, its terms are likely to exclude any frustration claim (discussed in the next section of this alert).[14] Thus, the broader and more general the definition of "force majeure event", the more likely the clause is to govern the consequences of frustrating events exclusively (although, as noted, courts seek to construe force majeure clauses narrowly). That is particularly relevant in the context of construction contracts, whose standard forms (with the arguable exception of the JCT suite) adopt very general definitions of force majeure.

The standard forms

Each of the main standard forms in use in the UK and on many international projects provides that force majeure can operate so as to suspend performance by the affected party and, in certain circumstances, entitle either or both parties to terminate. The analysis below focuses on force majeure provisions, but it should be borne in mind that other provisions of a contract may also provide relief or otherwise be relevant where it is claimed that matters arising out of the spread of the coronavirus have affected progress on a project. Our analysis takes a representative example of each of the main standard form construction contracts: JCT, FIDIC and NEC.

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[9] *Channel Island Ferries Ltd v Sealink (UK) Ltd* [1988] 1 Lloyd's Rep. 323, 327, 328; *Mamidoil-Jetoil Greek Petroleum Co SA v Okta Crude Oil Refinery AD (No.2)* [2003] EWCA Civ 1031.

[10] *Trade and Transport Inc v Iino Kaiun Kaisha Ltd* [1973] 1 W.L.R. 210, 224–227.

[11] *Channel Island Ferries Ltd v Sealink United Kingdom Ltd* [1988] 1 Lloyd's Rep. 323, *Tandrin Aviation Holdings Limited v Aero Toy Store LLC., Insured Aircraft Title Service, Inc.* [2010] EWHC 40 (Comm), 2010 WL 19913 at paragraph 43.

[12] *Channel Island Ferries Ltd v Sealink United Kingdom Ltd* [1988] 1 Lloyd's Rep. 323, 327.

[13] In particular, the courts have, some commentators argue, recently loosened a similar rule that was thought by many to apply to exclusion clauses (see *Transocean Drilling UK Ltd v Providence Resources Plc* [2016] EWCA Civ 372)). Since force majeure clauses are sometimes regarded as a species of exclusion clause, parties invoking them may seek to rely on that parallel development to contend that the courts should interpret them more liberally than the older cases suggest.

[14] See, e.g., *Larrinaga & Co v Société Franco-Américaine des Phosphates de Medulla* (1923) 92 L.J.K.B. 455 and *The Maira (No 2)* [1985] 1 Lloyd's Rep. 300.

- JCT[15]

Summary

  - The JCT contract's provisions addressing force majeure are, in general, particularly unfavourable to contractors seeking relief from performance. There are no reported cases in which these provisions have successfully been invoked.

  - The form provides for relief in circumstances where certain events that are not expressly defined as force majeure interfere with performance.

  - The JCT contracts offer a graduated set of remedies to the party seeking relief. The default position is that force majeure (or the other events specified) entitles the affected party to extend the time for performance.

  - If the disruption lasts longer than a stipulated period, both the affected party and the other party become entitled to terminate, triggering a secondary set of obligations upon the contractor to unwind the contract. The contractor is entitled to a measure of compensation in such circumstances.

Demonstrating the occurrence of force majeure

"Force majeure" is a "Relevant Event" entitling the contractor to an extension of the time for completion pursuant to clause 2.29.14 of the standard form. It is also mentioned in clause 8.11 as a possible ground for termination. However, nowhere is the term defined. Since the concept of force majeure takes its colour from the words of the clause (and, as already stated, the term on its own has no particular meaning under English law), the bare definition in the JCT form is of uncertain scope and meaning.

This uncertainty is not alleviated by the fact that, elsewhere in the standard form, events that might be thought of as force majeure are separately identified as potentially entitling a contractor to seek an extension of time in clause 2.29 (exceptional weather, civil commotion, and strikes among them). This could be, and generally is, taken to show that such events are outside the scope of the JCT's concept of force majeure. That suggests a very narrow and obscure definition indeed.

The sparse definition of force majeure in the JCT form forces parties seeking to rely on it to look to judicial decisions for guidance. That guidance is essentially limited to the case of *Lebaupin v Crispin*.[16] The relevance of the decision lies in its overview of previous cases addressing the meaning of force majeure in English contracts. The decision dates from 1920

[15] JCT clause references below have been taken from the 2011 edition of the Standard Form of Building Contract with Quantities.
[16] [1920] 2 K.B. 714 (18 June 1920).

and is a little stale. In the case, the High Court explicitly held that "*epidemics are cases of force majeure*".[17] However, this does not by any means suggest that a claim founded on such basis is likely to be successful. The starting point remains the terms of the clause and the relevant context in which they sit. There is no specific judicial guidance as to the effect of the JCT contract's force majeure terms, and they may, on close analysis, not extend to the events produced by the present crisis.

Beyond the concept of force majeure itself, the JCT form provides that the exercise by the government of the United Kingdom of a statutory power which "*directly affects the execution of the Works*" (clause 2.29.13) is an event entitling the affected party to relief. Given the unprecedented and sweeping array of emergency statutory powers recently passed by the United Kingdom's Parliament, this clause is likely to become relevant to works being performed in the United Kingdom under JCT terms in circumstances where the ability to seek relief for force majeure is uncertain.

Relief

Where the force majeure event or exercise of a statutory power causes a delay to completion of any part of the works, it is a Relevant Event entitling the contractor to an extension of time (upon giving notice). The precise extension is determined by the architect or administrator (clauses 2.27 to 2.28).

At first, the only consequence of this is that deadlines for performance are deferred to a later date. The substance of the affected obligations persists, supplemented by a duty on the contractor to use its *best* endeavours to overcome and minimise the disruption (clause 2.28.6). There is no provision for any compensation to be paid as a result of the event. The obligation to use best endeavours to overcome and minimise the disruption can be onerous. There is little doubt, for example, that it requires the party subject to it to incur expense.[18]

If the delay exceeds a contractually stipulated period, a termination right arises in favour of both parties.

A terminating party must establish that the delay occurred "by reason" of one of certain specified events (including force majeure or the exercise of a statutory power by the United Kingdom government). This is a significant point. There must be a close causal relationship between the relevant event and the disruption. In practice, the disruption is likely to be the product of multiple, competing factors. Care must be taken to disentangle the effects of the force majeure event from those of other events contributing to the cessation of performance.

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[17] Ibid.

[18] See, e.g., *Jet2.com v Blackpool Airport Ltd* [2012] EWCA Civ 417.

Notably, the JCT form does not allow parties to terminate except where there has been a continuous delay of the relevant duration. It differs in this respect from other forms, such as the FIDIC suite. This may prove significant in the present context. In the United Kingdom at least, government strategy presently assumes that the outbreak will be contained by periodic suppressive measures, potentially for as long as it takes to develop and deploy a vaccine. If suppressive measures are in force only intermittently, they may prove insufficient to engage the termination provisions of the JCT form. By contrast, the termination provisions of other standard forms, most obviously those of the FIDIC forms, may be engaged.

The JCT form contains a procedure, at clause 8.12, governing the consequences of termination for force majeure. In short, the usual payment obligations cease. The contractor is obliged to clear the site and remove unused materials. It must also prepare an account of the costs of doing so and of the reasonable value of any work that it has performed but for which it has not yet been paid. The contractor is also entitled to any "direct loss" caused by the termination, potentially opening up a claim of substantial value.

- FIDIC Silver Book[19]

  Summary

  - The FIDIC Silver Book (and other contracts in the FIDIC suite) sets out a more generous force majeure regime than the JCT form, but the risks of non-performance still tend to fall on the contractor.
  - Force majeure is broadly defined, although it will only relieve a party from performance where performance is "prevented" by the relevant event.
  - This imports a high level of disruption with a close causal relationship with the event. The threshold is therefore a high one.
  - As under the JCT regime, relief from performance is initially temporary, but can entitle the affected party to terminate if the disruption lasts for long enough.
  - If the contract is terminated, an engineer is appointed to attribute a value to works and materials that have been delivered but not yet paid for, and otherwise to allocate the losses resulting from termination.

[19] Force majeure is addressed in clause 19 of the first edition of the FIDIC Silver Book published in 1999. In the second edition, which was published in 2017, the term "force majeure" has been replaced with "exceptional event" and the relevant provision is now clause 18, although the substance of the provision remains largely unchanged. However, as the first edition of the FIDIC Silver Book remains in wide use, this article refers to clause 19 of the first edition and retains the term "force majeure".

Demonstrating the occurrence of Force Majeure

Clause 19 of the FIDIC Silver Book defines "Force Majeure". The definition is expressed in general terms and illustrated by a non-exhaustive (and, importantly, non-limiting) series of examples. Because the examples do not include epidemics or government interference *per se*, the general definition must be considered.

"Force Majeure" occurs where four criteria are met:

(i) an "*exceptional event or circumstance*" beyond the affected party's control must have occurred;

(ii) the event must be of such a nature that the affected party could not reasonably have provided against it before entering into the contract;

(iii) the party relying on the event to relieve it from performance could not reasonably have avoided or overcome the event or circumstance once it arose; and

(iv) the event or circumstance is not substantially the result of an act or omission by the counterparty.

Contractors might point to the various characteristics of the coronavirus pandemic – its spread across so many parts of the world with such-wide ranging effects on many aspects of commerce, etc. – to argue that it must be a Force Majeure Event. However, contractors (if properly advised) might also consider their other potential remedies under the FIDIC forms in connection with the various governmental responses seeking to slow the spread of the virus. Under the FIDIC forms, a contractor is entitled to an extension of time and payment of additional costs arising from any change in the laws of the country in which the project is located. Accordingly, a government-imposed lockdown in that country which prevents construction works proceeding for a time may give a contractor a claim for an extension of time and payment of additional costs even if the lockdown would otherwise satisfy the definition of "Force Majeure Event". Such a claim would likely be more favourable to a contractor than a force majeure claim as the latter would not entitle the contractor to payment of the additional costs arising from the Force Majeure Event. However, changes in law outside the country in which the project is located would not give the contractor any such claim, but may still be a Force Majeure Event. The interactions between these provisions of the FIDIC forms also underscore the importance for both a party considering claiming force majeure and a party receiving a force majeure notice to consider carefully the Force Majeure Event relied upon.

Assuming that there are one or more events of Force Majeure, the contractor must show that it "is or will" thereby be "prevented" from performing "any" of its obligations (and notify that fact to the employer within 14 days of becoming aware of the problem).

Since the virus's consequences potentially include so many events of Force Majeure, and since the notice must, in broad terms at least, state the link between the Force Majeure event and the prevention of performance, notices are likely to identify as many events of Force Majeure as is possible at this stage.

Showing prevention (as opposed, for example, to hindrance, delay or increased cost) is generally challenging, but in the context of so extreme a crisis as the present, it is likely to be possible in some contracts.

Relief

Like the JCT form, the FIDIC regime provides for a graduated approach to relief in which the relief becomes more generous as the disruption worsens.

The general rule established by clause 19.4 of the FIDIC Silver Book is that the relief available to the affected party following Force Majeure is limited to an extension of the time for performing the affected obligations (corresponding to the period of time for which it is unable to perform those obligations). In practice, that is usually the full extent of the available relief. It does not cancel the affected obligations. Nor is it an opportunity to rewrite or escape from a difficult contract. It also does not involve compensation for the affected party for any additional costs which it may occur, save in certain circumstances described in clause 19.4(b) (which have to do with the examples of Force Majeure given in clause 19.1 and are thus unlikely to be relevant to contractors affected by the coronavirus crisis).

However, if performance is continuously prevented for 84 days (or intermittently for a total of 140 days in aggregate), the Contractor may terminate. Unlike the JCT form, the termination right is not bilateral. It is of course to be hoped that the disruption caused by the present crisis is not extensive enough to engage these termination provisions, but the possibility cannot be excluded. As noted above, current government strategy may produce intermittent waves of disruption to construction contracts. Over time, it is possible that these will exceed the 140 day period after which the affected party may terminate. Both contractors and employers would be well advised to monitor such disruptions and their causes closely, keeping written records wherever possible.

- NEC 3[20]

Summary

The NEC contracts move furthest from English law's traditionally unforgiving treatment of contractors, and towards the more egalitarian distribution of risk that is favoured by continental legal systems.

[20] NEC clause references are taken from NEC3 ECC (Engineering and Construction Contract) given that common usage of that form remains.

Events preventing or delaying performance that cannot themselves be prevented and for which an experienced contractor would not ordinarily make provision in its planning, are considered force majeure events. So too are changes in the law that render performance illegal.

The occurrence of such an event suspends performance (whether until it can safely resume or permanently). Contractors, unlike their counterparts under the JCT and FIDIC regimes, receive compensation (via the mechanism of "compensation events", which recurs throughout the NEC 3 suite).

Demonstrating the occurrence of force majeure

NEC 3 titles its primary force majeure clause (clause 19.1) "Prevention". This provision covers events that either stop the contractor from completing the works or make it impossible for it to complete on time. It establishes two basic types of force majeure event:

- One stopping the contractor from completing the works altogether; and
- One stopping the contractor from completing the works on time.

This is a broad definition which looks to the effects rather than the nature of the event. It is plainly likely to extend to many of the effects of the coronavirus.

However, not all events of these type entitle the party to relief. The event must also:

- Be beyond either party's power to prevent; and
- Be sufficiently unforeseeable or remote that an experienced contractor would have considered it unreasonable to make provision for.

On the occurrence of such an event, the project manager assumes responsibility for determining the consequences:

> "*He may decide to abandon the work because the project is no longer viable – the Employer terminates under the contract. He may decide to change the work to overcome the problem – a change to the works information. A third option is to allow progress to be delayed until the event is overcome, and accept a delay to completion. Whatever action the Project Manager takes, the event itself is a compensation event, and in addition the instruction of the Project Manager changing [the] works information would be a further compensation event.*"[21]

There is no requirement to give notice.

[21] Peter Higgins, "Prevention under the NEC Contracts" (NEC Panel Briefing, NECP/BO3).

In addition, clause 18 stipulates that if a contractor discovers that the works information requires it to do anything which is illegal or impossible, it must immediately notify the project manager. If the project manager agrees, it gives an instruction to change the works information appropriately. As with the other standard forms discussed above, contractors may also consider other potential remedies under the NEC form to the extent that the event for which relief is sought constitutes a change in the law of the country in which the site is located. Under the NEC form, and subject to compliance with notice requirements, a contractor is entitled to claim an adjustment of the completion date or key dates, along with a change to the prices, where arising from such change in the law. Again, such a claim may be more favorable to a contractor depending on the particular circumstances.

Relief

By comparison with the other forms, the most striking feature of NEC 3's provisions is the breadth of the compensation provisions. An event of force majeure (or, in the language of clause 19.1, "Prevention") is a compensation event (clause 60.1(19)). So too is an event causing performance to become illegal (clause 60.1(1)).

A suggested checklist for evaluating the applicability of a force majeure clause

- Focus on the wording of the clause. Avoid the trap of assuming that extraordinary circumstances and extraordinary financial hardship are enough to amount to force majeure without more. In every case, the question depends on close and careful analysis of the terms of the provision, drawing where relevant on guidance in case law (but bearing in mind that the circumstances of every contract, and every case, will be different).

- Consider whether an event of force majeure has occurred. Again, this starts with the definition of force majeure. How broad is it? Does it require the occurrence of a specified event from a list, or is the definition more general (as in the standard forms)? Also, remember that "unlikely" is not the same as "unexpected" or "could not reasonably have been anticipated".

- Establish the exact cause of the impediment to performance. It may be tempting to think of every element of the response to the pandemic of governments, companies, and other organisations as facets of the pandemic itself, but that assumption is liable to produce a flawed analysis. What, exactly, causes the impediment to performance? Is it government quarantine measures that render performance illegal? Is it the knock-on effect of a border closure? Is it employees' unavailability to work on site? Which of these events is the sole operative cause, if it is possible to identify one? Once the causative event has been established, ask: does that event qualify as force majeure as defined in the clause, and why?

- Does the event impede performance to the necessary degree? Does the contract require prevention, hindrance, or delay to performance for relief to become available and if so, is that test satisfied?

- Consider what the parties could reasonably have done to plan for or mitigate the event at the time of contracting. Was the event foreseeable at the time of contracting, and could something have been done to avert its effects? Consider seeking subject matter expert advice.

- Consider alternative means of performance. If the impediment arises from the unavailability of workers in a particular area, is it possible to recruit from a nearby region? If there is any chance that it is possible, attempting the alternative performance is advisable. The existence of alternative means of performance would tend to suggest that there has not been sufficient impediment to performance enlivening a force majeure clause.

- Prepare evidence. The burden of proof is on the party seeking relief. Contemporary records regarding when the event arose, when it and/or its effects were identified, what steps were taken to minimize its effects, etc. should be kept.

- Give notice. Force majeure clauses are effective only on their terms and are strictly construed. Notice provisions must therefore be complied with scrupulously, with particular attention paid to time limits, which are generally enforced by English courts.

V. Supervening Illegality, Frustration, and Severance

The most direct and immediate threat to many construction contracts posed by the coronavirus is simple: as government lockdowns grow in number and scale, performance may become illegal. While the measures prohibiting performance will almost always be temporary, they will mostly be of open-ended duration, and may last for some months.

The affected contracts may well be "frustrated" and come to an end. However, the doctrine of frustration is not the law's only response to supervening illegality.

English courts seek to apply the principle, sometimes referred to as "sanctity of contract"[22], that contracts must be adhered to. This generally requires parties either to perform their obligations or render their financial equivalent in damages. It is only in the most extraordinary circumstances that exceptions are made to this rule.

Reflecting this concern, where performance of a contract becomes partially illegal, the courts often try to save it. They use the following tools to do so:

[22] Or by reference the Latin maxim: "*pacta sunt servanda*". See generally *Frustration and Force Majeure* 3rd Ed. 2-037 to 2-038.

- The doctrine of *severance*. Severance is the contractual equivalent of surgery, cutting the specific terms that are tainted by the illegality from the agreement so that the others can continue in effect.

- By looking to *the terms of the contract itself*. Where the parties have given some indication as to what the consequences of supervening illegality should be (and those consequences are not themselves illegal), a court will not generally usurp that allocation of risk. Force majeure clauses, many of which provide for the consequences of supervening illegality, are the classic case of such risk allocation.

However, in some cases, the contract is beyond saving. Performance may have become wholly illegal. Alternatively, the illegal part may be too fundamental to the parties' bargain for the contract to continue in anything other than a radically different form to that originally contemplated.[23] In these cases, frustration – specifically, frustration for illegality – intervenes to bring the agreement to an end.

Frustration applies in other cases where performance becomes impossible. Our primary focus in this update is on frustration for illegality, which is perhaps the most likely cause of frustration arising from the coronavirus crisis.

In practice, parties should note that severance (on the one hand) and force majeure / frustration (on the other) are different points on the same spectrum. The broader the impact of governmental interference on a contract as a whole, the more likely the latter are to apply. Where legislative action is relatively limited in its impacts, it is more likely that the affected terms may be severed from the contract. Each possibility should be considered in any situation in which the legal and administrative response to the coronavirus affects contractual performance.

VI. Frustration

The doctrine generally

The doctrine of frustration operates to discharge a contract when something occurs after the formation of the contract which renders it physically or commercially impossible to fulfil, or transforms the obligation to perform into a radically different obligation from that undertaken at the moment of entry into the contract.[24]

This apparently straightforward summary belies the exceptional difficulties facing a party seeking to prove that a contract has been frustrated. In general, performance must be genuinely impossible. For instance, it might be that a law has been passed making it wholly illegal to deliver the contracted-for works, or the physical goods to be sold or hired might have been destroyed (and even then, unless the goods are unique, the law generally expects the seller to try to find and acquire sufficiently similar goods to meet its obligations). It is not enough that performance would merely inflict extreme, even ruinous, hardship on the performing party. If there is a manner of performing

[23] Less pertinently for present purposes, if the illegality is very serious, public policy may require a more robust response than severance or the terms of the contract can provide.
[24] Chitty on Contracts, 33rd Ed. 23-001.

the contract which approaches the manner originally contemplated by the parties, that must be done, irrespective of the burden.

The courts are vigilant to keep the doctrine within tight bounds, ruling that it "*must not be lightly invoked and must be kept within very narrow limits*"[25] and "*ought not to be extended*".[26] This strictness reflects the principle. The courts' reluctance to find in favour of a party relying upon frustration also reflects an awareness that it is a blunt instrument whose results are often drastic, unpredictable, and unfair. Frustration operates to "*kill the contract*".[27] All of the parties are discharged from further performance of all of their obligations.[28] However, the losses that inevitably result do not always lie where they fall.

The Law Reform (Frustrated Contracts) Act 1943 provides as follows:

- Any sums paid before the frustrating event are to be repaid.[29]
- Money due before the frustrating event, but not in fact paid, ceases to be payable.[30]
- The court has a discretion:
    - to permit a party that has incurred expenses to deduct the value of the expenses out of any sums they were paid by the other party before the frustrating event;[31]
    - if a sum was due to a party at the time of the frustrating event, to permit that party to claim its expenses from that sum;[32] and/or
    - to require a party which received valuable benefit pursuant to the contract before the occurrence of the frustrating to pay a "just" sum.[33]

As is clear from this summary, these provisions are dependent on the exercise of a discretion by a judge, who is necessarily relatively remote from the commercial reality of the contract and relationship. Their operation is therefore unpredictable.

Frustration for illegality

As the coronavirus crisis develops, the doctrine of frustration is likely to play a particularly important role in unwinding contracts whose performance has become illegal. The case law addressing situations of this nature is highly developed, due in part to the frequency with which wartime measures (such as, for instance, embargoes on trade with Europe[34] and domestic restrictions and

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25 *J Lauritzen AS v. Wijsmuller BV, The "Super Servant Two* 29 [1990] 1 Lloyd's LR 1 at 8.
26 Ibid.
27 *J Lauritzen AS v. Wijsmuller BV, The "Super Servant Two* 29 [1990] 1 Lloyd's LR 1 at 8.
28 Except governing law, jurisdiction, and arbitration agreements.
29 The Law Reform (Frustrated Contracts) Act 1943, s. 1(2)
30 Ibid, s. 1(2).
31 Ibid, s. 1(2).
32 Ibid, s. 1(2).
33 Ibid, s. 1(3).
34 See e.g. *Fibros Spolka Akcyjna v Fairbairn Lawson Combe Barbour Ltd* [1943] AC 32, in which an English company agreed in 1939 to sell machinery to a Polish company and to deliver it to Gdynia, which became illegal when that port was occupied by the Germans later the same year.

requisitioning[35]) interfered with the performance of English-law governed contracts during the 20th century.

- The primary difficulty posed in cases of frustration for illegality is whether the illegality interferes enough with the bargain to warrant the discharge of the contract as a whole. This depends on whether the supervening prohibition affects the "main purpose" of the contract.[36]

- It can be difficult to judge what the main purpose of a contract is (or what a judge might regard it to be). That is particularly so in complex construction projects. Such projects tend to have many components, each of which may be a substantial and important piece of work in its own right, but the components may be interrelated (e.g. a project consisting of multiple buildings serving different purposes, and all served by a single services building).

- As a general rule, the "main purpose" of the contract is often counterintuitively narrow. Courts may find a contract's main purpose to be capable of fulfilment even when the majority of what might be regarded as the commercially important elements or objectives of the bargain can no longer legally be delivered. This may be illustrated by reference to the 2010 case of *Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association Ltd*.[37] A shipping company took out broad ranging insurance, addressing a wide variety of events and risks, with an insurer. The United Kingdom government subsequently added the defendant to a blacklist of organisations suspected of involvement in terrorism. That rendered almost all of the insurance coverage under the policy illegal, but another decree exempted the parts of the policy that provided coverage in respect of certain oil spills. Performance of the contract thus became largely illegal but partly lawful. The court enforced the contract, finding that it was not frustrated. Its main purpose, the judge found, "*was to provide indemnity insurance*" and "*although the scope of cover is significantly narrower than it was before [the blacklisting] ... its nature is not different. It remains indemnity insurance*".[38]

- A contract will generally survive where a "non-trivial" part of the contracted performance can still be rendered. In the leading case, *Leiston Gas Co v Leiston-cum-Sizewell UDC*,[39] a gas company was contracted to install, maintain, and (every night for five years) light street lamps. Following the outbreak of World War I, a black-out was ordered, making it illegal to light lamps at night. Despite the fact that the intended ultimate outcome, gas-lit streets, became impossible for the indefinite future, the contract was not frustrated. The reason for this was that a part of the performance that could "*not be regarded as trivial*" remained lawful.[40]

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35 *Metropolitan Water Board v Dick, Kerr & Co Ltd.* [1918] A.C. 119; *Denny Mott & Dickson v James B Fraser & Co Ltd* [1944] A.C. 265.
36 *Denny Mott & Dickson Ltd v James Fraser & Co Ltd* [1944] A.C. 265. p. 271.
37 [2010] EWHC 2661 (Comm)
38 Ibid at para 115.
39 [1916] 2 K.B. 428.
40 Ibid. at 433.

- Notably, frustration for illegality can occur even where the illegality is merely temporary. For instance, in the World War II case of *Denny Mott & Dickson Ltd v James B Fraser & Co Ltd* ,[41] the illegality arose from regulations which would not last beyond the end of the war. It was enough that the interruption was long enough to destroy the essential identity of the works. Knowing exactly when that line has been crossed is very difficult. However, frustration for illegality is more generous in this regard than the general doctrine, which requires "*abnormal*" delay as a condition to relief.[42]

Illegality in cross-border contracts

Cross-border contracts are likely to be particularly disrupted in the next few months as national governments around the world grapple with epidemics of varying speed, scale, and lethality. Contractors may well find themselves in the (unenviable) scenario in which their English law contract requires them to do something that breaches foreign but not English law (or vice versa).

Reflecting its internationalism, English law accommodates this possibility. Whether an affected contractor can escape the contract on the grounds of illegality will depend on whether the performance is illegal in the *place where it was due to be rendered*. If so, the contract may be frustrated. If not, a frustration argument based on illegality will fail. In a recent example of how this doctrine works in practice, a European Union agency's lease in London was held not to be frustrated by Brexit, despite the agency's claim that its organizing statutes required it to be based in an EU member state. What mattered was that the obligation could be performed under the laws of the place where the building was located.[43]

The process of determining the law of the place of performance can be complex, but that is beyond the scope of this update.

Interaction with force majeure clauses (and other contractual allocations of risk)

In practice, construction contracts tend to be particularly unforgiving to parties seeking to allege frustration. The reason for this is that most construction contracts contain force majeure clauses. Such clauses have the incidental effect of shutting out arguments that an event within the clause's scope has frustrated the contract. In the eyes of an English court, parties who agree to a force majeure clause have – almost by definition – considered the circumstances in which supervening events should entitle them to cease performance. As such, they may be taken to have established a contractual code covering, or at least heavily encroaching on, the same ground as the common law doctrine. If they have thus (effectively) "contracted out" of frustration, the courts will have no hesitation in permitting them to do so. Faced with a choice between giving effect to the parties' (albeit presumed) intentions and the blunt instrument of frustration, they will choose the former. Freedom of contract trumps the policies underpinning the doctrine of frustration.

The presence of a force majeure clause is not, however, necessarily fatal to a frustration argument. As explained above, the courts generally interpret such clauses restrictively. One of the

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41 [1944] A.C. 265. p. 271.

42 *Blankley v Central Manchester And Manchester Children's University Hospitals NHS Trust* [2015] EWCA Civ 18.

43 *Canary Wharf v European Medicines Agency* [2019] EWHC 335 (Ch).

consequences of this is that words which would be wide enough to capture a particular supervening event if taken literally may, on their true (strict) construction, leave room for the doctrine of frustration to operate.[44]

VII. Severance

Where performance of a contract is only *partially* illegal, English law may allow the objectionable term to be severed from the rest of the contract, with the result that the remainder of a contract is enforceable.

Severance can be thought of as the obverse of frustration for illegality. If a contract whose performance has become partially illegal is not frustrated for illegality, the part of performance that is illegal is severed from the agreement. Within that framework, it is often said that there are three requirements for severance to operate:

1. The "blue-pencil" test: can the unenforceable provision be removed without the necessity of adding or modifying the wording of what remains?

2. Adequacy of consideration of remaining terms: are the remaining terms supported by adequate consideration (i.e. was at least part of the contract price, or whatever was to be given in return for performance, paid/given in return for performance of such terms)?

3. Impact of removal of unenforceable provision on character of contract: does the removal of the unenforceable provision change the character of the contract so that it becomes "*not the sort of contract that the parties entered into at all*" (to use the words of one of the cases)?[45]

Although these general requirements will determine whether a particular term is severable, businesses will need to be aware that each case (and each contract) will need to be analysed carefully to achieve the correct result.

VIII. Repudiation

The perils of repudiation loom large over any party considering claiming frustration or force majeure. It is likely frequently to come into play in the coming months and years as contractors struggle to perform their contractual obligations.

Repudiation is the common law doctrine that provides for the consequences of a party's refusal to deliver the contracted-for performance. Following such a refusal, the innocent party has the choice either to demand performance (thereby "affirming" the contract) or to accept that the contract is at an end and claim its lost value (thereby "accepting" the repudiatory breach).

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[44] *Metropolitan Water Board v Dick Kerr & Co* [1918] A.C. 119; see also *Fibrosa Spolka Akcyjna v Fairbairn, Lawson, Combe Barbour Ltd* [1943] A.C. 32 and *Empresa Exportadora De Azucar v Industria Azucarera Nacional SA (The Playa Larga)* [1983] 2 Lloyd's Rep. 171.

[45] *Sadler v Imperial Life Assurance Company of Canada Ltd* [1988] IRLR 388 as quoted in *Beckett Investment Management Group Ltd v Hall* [2007] EWCA Civ 613.

Repudiation can occur in two ways. First, a party may fail to perform its contractual obligations when due. Alternatively, a party may indicate by words or conduct that it does not intend to be bound by an obligation that has yet to fall due for performance (often referred to as "anticipatory repudiatory breach"). This may arise inadvertently, including when a party is, in good faith, seeking to exercise a right which it believes it has but does not. For example, a notice stating that it will be impossible to carry out certain contractual obligations due to force majeure is a statement by the party issuing the notice that it does not intend to carry out the obligations in question. If the grounds for the force majeure claim are not made out, service of the notice may have amounted to an anticipatory repudiatory breach of the contract.

To amount to repudiation, the failure to perform must affect a fundamental element of the bargain, such as (for example) the obligation to pay the contract price. The test for the requisite breach is often described as requiring a refusal to perform an obligation that goes to the "root" or "essence" of the contract. The test is highly fact-sensitive, and whether it is met depends on the construction of the contract and the circumstances of the case. For example, in the case of construction contracts where the time of performance is stipulated to be of the essence, failure to perform by the time specified will be a repudiatory breach.[46] However, where time is not specified to be of the essence, delay in and of itself will rarely amount to a repudiatory breach (although it if coupled with other factors, such as a deliberate reduction in manpower).

Faced with a repudiatory breach, the innocent party may either "accept" or "affirm" the contract.

- In the first scenario, the contract ends. Both parties are discharged from further performance. While drastic, this can be to the considerable advantage of the employer, which becomes free to replace the contractor with a more competent firm and may also receive a windfall, for instance where it has received the benefit of some performance but not enough to trigger payment obligations. Subject to the requirement to mitigate its loss, it also generally acquires a valuable damages claim.

- Alternatively, the innocent party may insist on performance (and it may also claim damages for the loss caused by the breach, although the quantum of such damages would likely be less than the damages payable if it accepted the repudiation). In practice, affirming the contract is a viable strategy where there is still a measure of trust and goodwill between the parties. In the course of the present crisis, affirmation may be the logical step in many cases. Employers will, no doubt, often have cause for sympathy for contractors who are unable to perform. They may also be unable to find alternative contractors who could achieve the original objectives of the contract in the present circumstances.

Repudiation is likely to be the consequence where a party can no longer perform and is unable to invoke frustration or force majeure. It may also prove to be a consequence of the intermittent disruption to the performance of contracts that is likely as the coronavirus crisis unfolds. In particular, English law recognises a form of repudiation that may be termed "repudiatory creep" (or, more formally, "cardinal change"): a situation in which a party does not repudiate the contract all at once

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46 *Bunge Corpn v Tradax SA* [1981] 2 All ER 513.

but incrementally over time.[47] In this scenario, the party at fault gradually varies the manner of its performance until it is no longer doing what was originally promised.

It is easy to envisage scenarios in which the various pressures caused by the coronavirus will impel a contractor vary the scope of work, use different materials to those originally contemplated, or delay completion (for example). An employer faced with such conduct can consider asserting a repudiatory breach. While the factual investigation in such a scenario is different to that in a more conventional case, the legal analysis is, in substance, the same. The employer should:

- identify the scope of the performance that was promised by reference to the facts at the time of contracting; and

- establish what has in fact been (or will be) delivered.

If there is a fundamental difference between the two, it may be possible to allege a repudiation. Such an allegation may be deployed in various ways and to various ends.

- The innocent party – typically the employer – may make the allegation and reserve its rights to accept the repudiation or affirm the contract while it investigates the situation. This can, in the right conditions, set the scene for a negotiation in which the employer may obtain practical improvements to performance that are sufficient to justify continuing with the contract. However, a termination right is (in practical terms) a "use it or lose it" right. A right to repudiate could not be reserved indefinitely.

- Alternatively, the employer may simply inform the contractor of its position and state that it will treat the contract as discharged. This may be advantageous where, for instance, the employer wishes to replace the contractor. However, the employer should be careful not thereby to repudiate the contract itself.

IX. Material Adverse Change / Effect

Finance Agreements

In finance documents, a "material adverse change" generally arises where there is significant deterioration in the financial condition of the borrower that falls short of insolvency but nonetheless gives rise to a substantial risk of non-payment. The concept generally plays two roles:

- A material adverse change often qualifies as an event of default (including in the Loan Market Association's standard form facilities agreement). By calling an event of default, a lender can accelerate the outstanding loan, withhold any further advances, and generally be relieved of its obligations under the finance documents.

47 *Sanderson v Simtom* [2019] EWHC 442 (TCC). *See also C& S Associates UK Ltd v Enterprise Insurance Company Plc* [2015] EWHC 3757 (Comm), [2016] All ER (D) 19 (Jan).

- In addition, it is common for borrowers to be required to represent that there has been no material adverse effect at specified times (commonly as a condition precedent to each drawdown).

Historically, these "material adverse change clauses" ("**MAC clauses**"), whether structured as events of default or repeating representations, are rarely invoked in English-law governed finance documents. The primary reasons for this are that:

- Invoking a MAC clause carries serious risk. The consequences are particularly grave if the lender relies on the occurrence of an alleged material adverse change to refuse to provide further advances. In that scenario, the lender will have committed a serious breach of contract, most likely amounting to a repudiatory breach. It would thereby become liable to pay the borrower the damages necessary to put it in the position it would have been in had the advance been made. As might be expected, such damages can be very substantial.

- Establishing whether or not there has been a material adverse change is difficult. It is a concept of uncertain scope, occupying the hinterland between full-blown insolvency (usually provided as an event of default in its own right) and reasonable financial health. Reflecting this conceptual uncertainty, MAC clauses are often drafted in vague or imprecise terms. In practice, it is difficult both to identify what material adverse change is and to prove that it has happened.

The effects of the coronavirus on borrowers' finances may be sufficiently drastic to tempt many lenders to resort to this little-used event of default. It is perhaps more likely that most distressed situations arising from the coronavirus pandemic will be dealt with using other, clearer-cut contractual remedies (as was the case in the wake of the 2008/09 financial crisis). However, it is inevitable in a time of such unprecedented crisis that certain lenders will feel impelled to invoke this clause.

Material adverse change clauses

The concept of material adverse change varies, in large part because MAC clauses are usually heavily negotiated.

In the context of events of default, the definition is generally very broad. That is probably because such MAC clauses are intended to operate as a safety net, coming into play only where other, more precisely defined events of default are not available.

Where the agreement also contains a MAC clause that is structured as a repeating representation, the required "change" is sometimes (but not always) defined more narrowly. Often, such MAC clauses will specify that the change must be to the borrower's business or financial condition. However, broader definitions are not unusual, and sometimes drafters borrow the concept as it applies in the context of events of default and put it into service in the repeating representations.

The English case law

There have been only a small number of reported judgments from English courts examining the interpretation of MAC clauses. Perhaps the most useful guidance is to be found in *Grupo Hotelero*

Urvasco SA v Carey Value Added SL & Anor, which arose in aftermath of the 2008/09 financial crisis.[48] The particular MAC clause in question required the borrower to represent that there had been no material adverse change in the financial condition (consolidated if applicable) of itself and the other obligors since a particular date. If it failed to do so (or gave an untrue representation), the lender became entitled to withhold further advances. The court found for the lender, ruling that:

- There was a distinction between MAC clauses requiring the change to affect the "financial condition" of the borrower (as in the facilities agreement at issue) and those in which the change could be to its "business condition" (as in other documents in the suite which were not directly at issue). The first of these variants was narrower. The judge considered the latter to be broader.[49]

- "*To be material, the adverse change must be material in a substantial way to the borrower's ability to perform the transaction in question*".[50] The mere occurrence, for instance, of an event making it difficult or impossible for the borrower to borrow further sums would not be enough if the borrower remained able to perform its duties under its agreement with the lender.

- The lender cannot, in the absence of express words to this effect, trigger the clause on the basis of circumstances of which it was aware at the date of the contract. It will be assumed that the parties intended to enter into the agreement in spite of those conditions, although it will be possible to invoke the clause where conditions worsen in a way that makes them materially different in nature.[51]

- Finally, in order to be material, any change must be more than merely temporary.[52]

In addition to these observations, the Court commented on the proper approach to the evidence, at least in cases where the material adverse change required is to the company's financial (as opposed to business) condition. Mr. Justice Blair found that the best evidence of a company's financial information would generally be its formal accounts and other financial documents (as opposed, for example, to macro-economic conditions or its conduct or public statements).[53] Those materials are not, however, the only relevant evidence, and "*[t]here may be compelling evidence to show that an adverse change sufficient to satisfy a MAC clause has occurred, even if an analysis limited to the company's financial information might suggest otherwise*". For instance, a failure to pay other bank debts would be "*highly relevant to the question whether a material adverse change has occurred*".[54]

The extent to which these findings can be generalised into rules of thumb for other MAC clauses is unclear. They are expressed in broad terms that are relevant, on their face, to the interpretation of

48 *[2013] EWHC 1039 (Comm) (26 April 2013).*
49 Ibid, para 349.
50 Ibid, para 356-357.
51 Ibid, para 362.
52 Ibid, para 363.
53 Ibid, para 351.
54 Ibid, para 352.

most MAC clauses. However, the case was decided on the particular wording of the MAC clause at issue and on its own facts. Other MAC clauses may operate differently in practice.

COVID-19

The extent to which lenders will invoke their MAC clauses in the face of the coronavirus pandemic is difficult to predict, and lenders would be wise to be cautious, at least in the immediate term:

- It is unclear how long the various quarantine and social distancing measures will be in play. That is significant: a material adverse change must generally be permanent, not temporary. The scope for lenders to rely on MAC clauses thus depends, to some extent, on how long government lockdowns last in the relevant jurisdictions.

- The pandemic has had calamitous effects on global stock and financial markets. However, it would be unwise to suppose that the mere fact that the financial system is in meltdown, dramatic as that is, amounts to a material adverse change in the borrower's financial or business condition. Even the most disastrous macro-economic events are unlikely to be material adverse changes in and of themselves. Unless and until their effects manifest themselves in the borrower's financial position (or even, potentially, its financial documents), any MAC clauses are unlikely to be engaged.

- The final, and perhaps most important, source of uncertainty arises from the measures adopted by Western governments to shore up the financial system and real economy. Those measures are of unprecedented scale and depth, but no-one is yet sure how effective they will be. The most important factor in lenders' ability to rely on their MAC clauses may prove to be whether, and to what extent, governments and central banks are able to contain the economic damage.

Acquisition Agreements

Many merger and acquisition and similar agreements contain a so- called material adverse change or material adverse effect clause or condition ("MAC" or "MAE") that allow a buyer to terminate the agreement in the event of a material adverse event affecting the target's business, financial position, profits or prospects. English courts have held that such clauses are enforceable[55] but there is otherwise little case law in England providing guidance as to when they can be invoked.

Some guidance has been provided by the Panel of Takeovers and Mergers in relation to MAC clauses in relation to takeovers or mergers of listed companies. The City Code on Takeovers and Mergers (the "**City Code**") provides a set of principles and rules that apply, broadly speaking, to listed companies which have their registered offices in the UK. The City Code has statutory force. Its rules regulate the use of conditions in offers, including MAC conditions. Rule 13.5(a) provides that:

> "An offeror should not invoke any condition … so as to cause the offer not to proceed, to lapse or to be withdrawn unless the circumstances which give rise to the right to invoke the

[55] *Kitcatt v MMS UK Holdings Ltd* [2017] EWHC 675 (Comm); [2017] 2 BCLC 352.

condition … are of material significance to the offeror in the context of the offer."

The Panel of Takeovers and Mergers (the "**Panel**"), the body which administers the City Code, has issued a Practice Statement on the invocation of conditions, which provides guidance on Rule 13.5(a):

- the appropriate test for the invocation of a condition is whether the relevant circumstances upon which the offeror is seeking to rely are of material significance to it in the context of the offer – which must be judged by reference to the facts of each case at the time the relevant circumstances arise;
- in the case of a MAC, or similar, condition, whether the above test is satisfied will depend on the offeror demonstrating that the relevant circumstances are of very considerable significance striking at the heart of the purpose of the transaction; and
- whilst the standard required to invoke such a condition is therefore a high one, the test does not require the offeror to demonstrate frustration in the legal sense.

In considering whether a particular matter should give rise to the right to invoke a condition, the Panel takes into all relevant factors, including whether: the condition was the subject of negotiation with the offeree company; the condition was expressly drawn to offeree company shareholders' attention in the offer document or announcement, with a clear explanation of the circumstances which might give rise to the right to invoke it; and the condition was included to take account of the particular circumstances of the offeree company.

The Panel considered Rule 13.5(a)'s predecessor in the case of WPP Group Plc and Tempus Group Plc, where the offeror sought to withdraw from its offer after the September 11 attack on the World Trade Centre, which caused a significant downturn in the advertising industry (in which both WPP and Tempus operated). The basis on which the offeror sought to withdraw from its offer was a MAC condition. The Panel ruled that the offeror must proceed with its offer. To rely on a MAC condition, the offeror must establish that exceptional circumstances have arisen affecting the offeree company which could not have reasonably been foreseen at the time of the announcement of the offer. The effect of the circumstances must be sufficiently adverse to meet the high test of materiality and judged not in terms of short term profitability but on their effect on the longer term prospects of the offeree company.

Irrespective of whether the Panel's guidance applies to a particular contract, determining whether a change has been "material" will always depend very much on the contract in question and its subject matter. Ultimately, the decision as to whether there has been a MAC is likely to be a subjective one. Even in connection with the current crisis, one could mount compelling arguments and counterarguments as to whether the spread of COVID-19 is a MAC. For example:

- The COVID-19 pandemic is having (or is predicted to have) a widespread (and potentially severe) effect on most of the world's economies, which was unforeseen until very recently. However, while a pandemic of this nature might have been considered unlikely, it arguably was not unforeseeable because large-scale epidemics have occurred in certain parts of the world in recent years.

- At the present time (which may still be a relatively early stage of the pandemic), the COVID-19 pandemic may not have had a long-term material impact on the financial positions of many businesses. However, MAC clauses in merger and acquisition agreements often contain reference to the offeree's "prospects". An offeror is likely to argue that, even if the pandemic has not had a material impact on the business or financial position or profits of the offeree company to date, it has had a material impact on the *prospects* of such a business. Offerees may counter that most acquisitions are motivated by long term prospects, not short term profitability, and, at this time, there is no basis to think that COVID-19 will impact long term prospects (although, clearly, for some industries it may well do so).

The entity seeking to rely upon a MAC clause will bear the burden of establishing that all of the conditions to the clause have been satisfied. Contemporaneous documentary evidence from the period leading up to the execution of the relevant agreement may be key to establishing whether the nature and extent of the adverse change relied upon is genuinely material to the party seeking to exit an agreement.

Ultimately, it may be premature to tell how long-lasting the effects of the COVID-19 epidemic will be. But if corporate earnings are depressed and analysts predict potential longer-term effects for certain companies and industries, MAC clauses may become relevant.

X. Indirect Impacts on Contractual Performance

Finally, businesses should consider the risks associated with requiring part or all of their operations to continue in the current circumstances and their potential liability to individuals in tort. While the duty of care owed under English common law is not unlimited, a business which requires its operations to proceed, or requires contractors to continue to perform their services, may, in extreme circumstances, be argued to be in breach of a duty of care to its staff or the staff of contractors, and possibly even the public at large, if its actions expose individuals to a greater risk of being affected by coronavirus or contribute to the spread of the disease.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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