COVID-19

Terminating and renegotiating existing commercial contracts

Introduction

It is important to consider the potential direct or indirect effects of the coronavirus outbreak on your existing commercial contracts. The impact will depend on a number of factors, such as business structure, business methods and the type of goods or services you sell.

If you expect the outbreak to have a negative effect on an existing commercial contract, such as higher production or regulatory costs that could impact profits, you may wish to try to renegotiate or terminate the relevant contract.

If the outbreak is likely to have a negative impact on a trading partner, you may wish to take steps to protect your business from that trading partner ceasing to carry on business, or seeking to terminate or renegotiate a contract.

This factsheet outlines how a business may seek to terminate or renegotiate a commercial contract due to the coronavirus outbreak.

Do you need to terminate or renegotiate a contract?

In some cases, it may not be necessary to terminate or renegotiate your commercial contracts due to the coronavirus outbreak. For example:

- You are confident that you and your trading partner's ability to perform the relevant contract will not be affected.
- Where the risks of terminating the contract are higher than the risks of continuing with the existing contract.
- Where you enter into a short-term contract and can revise your terms and conditions of trading as and when necessary.
- Where you have the right to terminate or suspend the relevant contract without penalty on short notice.

Does your contract contain an "epidemic outbreak clause"?

An "epidemic outbreak clause" is a contract clause which alters (or permits a party to require the alteration of) the parties' rights and obligations as a result of a defined event occurring. It is similar to a material adverse change clause ("MAC" clause), albeit specifically focussed on the occurrence of an epidemic and/or specified events arising as a consequence of an epidemic. As such, it attempts to govern what will happen should the legal and business environment change in the future in much the same way as any other "if/then" clause.

If you entered into a long term commercial contract prior to the commencement of the coronavirus outbreak or the implementation of governmental (or other) restrictions (and, potentially, once it became known that the implementation of governmental (or other) restrictions may take place), there is a significant probability that that commercial contract will not contain an "epidemic outbreak clause". However, where similar events (such as the SARS or Ebola virus) have had an impact on businesses, such a clause may exist.

If your contract does contain an "epidemic outbreak clause", then you will need to assess whether that clause permits you to terminate the relevant contract, change the way in which certain parts of the contract operate or force the other party to renegotiate the contract. Each business, each contract and each set of circumstances are likely to be different. By way of example:

1. Specified consequence, specific event

In these types of case, the contract will specify the consequences (for example, the price of the products or services is adjusted) which follow upon the occurrence of a specific event (for example, fluctuation in currency exchange rates).

2. Trigger, renegotiation, termination

In these types of case, the contract specifies an event or range of events which act as a triggering event (for example a change in regulatory requirements or a party's costs increasing). If and when a triggering event occurs, the party affected by the epidemic outbreak may request renegotiation of the contract. If no deal can be reached, the affected party may terminate the contract. The party not affected by the epidemic outbreak faces the choice of accepting less favourable terms or early termination. The more broadly drafted the trigger, the greater the risk. The affected party may find the trigger too narrow to capture what has actually happened. In addition it has no certainty that it can reach a new deal.

If your contract has no effective "epidemic outbreak clause", on what other grounds may the coronavirus outbreak enable you to terminate your commercial contracts under English law?

The right to terminate a contract is likely to depend on the interpretation of the express terms of the relevant contract, but may also arise from implied terms of contract or English common law.

There are a number of clauses, which are sometimes included in commercial contracts (particularly long-term contracts), that may enable a party to terminate the relevant contract or provide the opportunity for a party to reduce its risk in relation to the relevant contract by bringing about changes to the contract by negotiation or otherwise. Alternatively, implied terms of contract or English common law may provide similar opportunities. These may include the following:

1. Force majeure clause

Force majeure clauses are frequently included in commercial contracts. They are often considered as being of possible assistance with the epidemic outbreak-type scenario, such as coronavirus.

The term “force majeure” has no general recognised meaning in English law. However, the underlying principle is that on the occurrence of certain events, which are usually wholly or partly outside a party's control, that party is excused from, or entitled to suspend performance of all or part of its obligations. In such circumstances, that party will not be liable for its failure to perform the obligations, in accordance with the clause. It is used in contracts because of the limited remedies available to parties under English common law when a contract becomes impossible to perform. The possibility of using it as a means of terminating a contract will depend on the exact words that the parties have used and how they are to be interpreted. Typically such a clause contains a non-exhaustive list of events that the clause is intended to cover. It may also specify a non-exhaustive list of events that the clause does not cover.

Unless the commercial contract was entered into very recently, it is unlikely that it will contain an express reference to the coronavirus outbreak. However, the force majeure clause may refer to epidemics (or similar matters), which may be interpreted as including the coronavirus. Alternatively, the clause generally may be interpreted as including the coronavirus.

Naturally, it may be that an event or series of events following the coronavirus outbreak (rather than the outbreak itself) amount to force majeure (for example, government action, new laws or regulations).

Where there is a force majeure event, the party seeking to rely upon it may need to overcome a series of hurdles in order to utilise a force majeure clause fully. These may include such matters as a foreseeability test and they will usually need to establish that it has prevented or hindered the party from performing the contract. These are primarily factual questions but will usually also involve an element of interpretation. A party claiming force majeure is under a duty to show that it has taken reasonable steps to avoid the events occurrence or mitigate its results.

Commercial contracts often set out the consequences of a force majeure event. They may include provisions relating to matters such as notice, meetings of the parties, contractual adjustments, re-negotiation, suspension, and termination. Once again, the nature of these clauses varies significantly and each of them will need to be assessed. In relation to force majeure events of a relatively short-term nature, it is more common to include adjustment or suspension provisions but this will inevitably vary depending on matters such as the type of goods and/or services and

industry norms. However, they often offer the option of terminating the contract if a force majeure event continues for more than a specified length of time. Again, that period of time is likely to vary depending on matters such as the type of goods and/or services and industry norms.

It may be that a *force majeure* clause will not assist in relation to the coronavirus outbreak, where the relevant contract was entered into after the commencement of the coronavirus outbreak or the implementation of governmental (or other) restrictions (and, potentially, once it became known that the implementation of governmental (or other) restrictions may take place). This is because (a) an event is only usually considered to be outside the control of a party if the party has taken all reasonable steps to avoid its operation or mitigate its results. If there was a possibility that the coronavirus outbreak may affect the contract when the contract was entered into, it could be argued that the parties could and should have planned for its effects. *(b)* A change in economic or market circumstances affecting the profitability of a contract or the ease with which the parties' obligations can be performed is not generally accepted as being a force majeure event. However, once again, this will be a matter of interpretation and will be dependent upon the specific facts of the case.

2. Material adverse change (MAC) clause

MAC clauses are less common than f*orce majeure* clauses. They are more commonly included in financial, lending or acquisition agreements.

They usually permit a party to terminate an agreement if an event occurs that is detrimental to that party (for example, the financial status of a borrower (or its subsidiary) in connection with a loan agreement).

Once again, the extent to which a party may be able to rely on a MAC clause when seeking to terminate an agreement due to the effects of the coronavirus outbreak will depend upon the interpretation of the relevant clause. A contracting party is not normally able to rely on a MAC clause in relation to circumstances of which it was aware (or ought to have been aware). Accordingly, any attempt to utilise a MAC clause contained in a contract entered into after the commencement of the coronavirus outbreak or the implementation of governmental (or other) restrictions (and, potentially, once it became known that the implementation of governmental (or other) restrictions may take place) in order to terminate an unwanted contract may be considered unlikely to succeed.

3. Frustration

A contract may be discharged on the ground of frustration when something occurs after the formation of the contract which renders it physically or commercially impossible to fulfil the contract, or transforms the obligation to perform into a radically different obligation from that undertaken at the moment of entry into the contract.

A claim that the coronavirus (or a coronavirus outbreak-related event) frustrates a contract could be challenged on the following grounds that: (a) The possibility of an epidemic was within the contemplation of the parties at contract formation. Whether this is the case will depend on matters such as when the contract was entered into, the nature of the event, the nature of the goods or services and the relevant geographical market. It is not enough that the event was merely unexpected. (b) The event does not make further performance impossible, illegal or radically different. The bar is set high by the courts. For example, it is not enough that the contract is merely more expensive to perform.

In the circumstances, it seems unlikely that a business will be able to terminate a contract because of the coronavirus outbreak where the contract was entered into after the commencement of the coronavirus outbreak or the implementation of governmental (or other) restrictions (and, potentially, once it became known that the implementation of governmental (or other) restrictions may take place). Where a contract was entered into prior to that time, there may be more scope for ending contracts on the grounds of frustration.

There are relatively few cases where parties to a contract have successfully claimed that a contract has been frustrated. Where the relevant clause contains a force majeure clause, it is more likely that parties will seek to utilise such clauses.

4. Compliance with law clauses

It is common for contracts to contain an express clause stating that the parties must comply with applicable law. In particular, a contract often defines the law as being "the law at the date of the agreement" or "the law as it may be amended from time to time". If the contract is silent on this point, it will generally be a matter of interpretation.

Where a contracting party is obliged to comply with "the law as it may be amended from time to time", the coronavirus outbreak may make a party's obligations substantially different to what they were originally or make it difficult or impossible for a party to comply with a contract. However, it is still likely to be a matter of interpretation as to whether such a clause could oblige a party to absorb the costs associated with a coronavirus outbreak-related change in law. Long-term agreements often expressly address what will happen if the law changes, for example by specifying that charges cannot be increased and requiring the supplier to consult with the customer before making any necessary changes to the services.

5. Change control clause

Long-term agreements often contain a clause setting out a procedure to follow when either party wishes to amend the contract. Typically, they allow either party to raise issues (often of an operational nature), and set out a process and timetable for discussing such issues and implementing any agreed changes. However, it is unusual for a party to be able to demand that any amendments it suggests take place and it is uncommon for there to be a right to terminate if a change (particularly a non-essential change) is not agreed.

It is unlikely that a change control clause could be used in order to terminate an unwanted contract. However, it may be of assistance if, for example, the way the contract is performed needs changing to reflect a coronavirus outbreak-related change in law.

6. Hardship clause

A long-term agreement may contain clauses which deal with which party should bear the burden of increases in costs of supply, fluctuations in interest rates or exchange rates, and other changes to factors that the parties took into account when they made the deal. Whether such a clause can be invoked when a coronavirus outbreak-related event occurs depends entirely on how the clause is drafted (for example, if it includes a mechanism for making price adjustments in specified circumstances).

It is unlikely that a hardship clause could be used in order to terminate an unwanted contract. However, it may be of assistance in connection with renegotiating a contract if, for example, the way the contract is performed needs changing to reflect coronavirus outbreak-related changes.

7. Interpretation and implied terms

The courts may be reluctant to interpret a contract or imply a term into a contract to assist a party who is adversely affected by the coronavirus outbreak. While interpretation should have regard to business common sense, this does not mean the courts will relieve a party from the consequences of their imprudence or poor advice, if that involves departing from the natural meaning of the contract. Similarly, the fairness of a proposed implied term or the fact that the parties would agree to it is (by itself) insufficient grounds for implying it. Both interpretation and implication of terms have regard to the background knowledge reasonably available to the parties at the time they entered into the contract.

In the circumstances, it seems unlikely that a term which would assist a contracting party in connection with the coronavirus outbreak could be implied into a contract where a contract was entered into prior to the commencement of the coronavirus outbreak or the implementation of governmental (or other) restrictions (and, potentially, once it became known that the implementation of governmental (or other) restrictions may take place) as it is unlikely that any such term would have been in the contemplation of the parties. Where the parties fail to specifically provide for the coronavirus outbreak after that date, they may be taken to have accepted that any additional costs and risks should lie where they fall.

8. Other contractual terms

Various other contractual terms (for example, assignment clauses or the existence of minimum purchase or sales targets or requirements) may enable a party to reduce its commercial risks. The ability to do so is likely to depend on the wording and interpretation of the relevant clause (for example, can a party assign the benefit and burden of a contract).

9. Business structure and restructuring

It is possible that the existing business structure of a party may enable that party to avoid or reduce some or all risks in relation to unprofitable or unwanted contracts (for example, where it has used special purpose vehicles) or to restructure its business in order to achieve the same outcome.

Conclusion

In the absence of an express reference to an epidemic (or pandemic or, specifically (and somewhat less likely), the coronavirus outbreak) in your commercial contract, it seems unlikely that you will be able to terminate your contract because of the coronavirus outbreak, particularly in relation to a contract entered into after the commencement of the coronavirus outbreak or the implementation of governmental (or other) restrictions (and, potentially, once it became known that the implementation of governmental (or other) restrictions may take place) unless you are able to bring it within the force majeure provisions albeit those usually provide for suspension rather than termination (at least for a period of time). In general terms, this is because a court is likely to take the view that the parties could and should have planned for its effects and would have done so if they had intended it to affect the contract. However, it may be that certain express or implied contractual provisions or English common law enable a party to require changes to contracts (typically, financial or operational changes) or that commercial inducements (for example, a longer contract or improved terms in other areas of a contract) may enable parties to resolve problems created by the coronavirus outbreak. It may also be in the commercial interests of both parties to find solutions to any problems created by the coronavirus outbreak.

Ultimately, the earlier you create your coronavirus strategy and more thoroughly you prepare and carry out your due diligence, the better your chances are of making your coronavirus strategy work. In order to maximise any benefits and minimise any risks of the coronavirus outbreak, you need to be as in control of the process as possible from start to finish, which requires detailed thought, preparation and planning. Determining your objectives and setting your goals early on, creating a viable plan and reviewing and revising it regularly (as several events may affect your plans over time) means that you will maximise your chances of being ready to take advantage of any good opportunity to develop your business or minimise any risks to your business as a consequence of the coronavirus outbreak.

If you would like more information about the contractual effects of the coronavirus outbreak, please visit www.orrlitchfield.com or email enquiries@orrlitchfield.com.

SUPPORTED BY
MAYOR OF LONDON

DISCLAIMER This information is for guidance only and should not be regarded as a substitute for taking legal advice.