COVID-19: Lessons Learnt in Commercial Contracts

The COVID-19 pandemic arrived out of the blue and engulfed the world like wildfire. It has become one of the greatest humanitarian challenges and the biggest health crisis of our times. However, every crisis teaches new lessons to the human race and some of those are in the way business is run today. These lessons will continue to apply in the future, of which the most important ones are resilience and flexibility of businesses.

Most commercial transactions throughout the world are conducted through contracts. Upon the onset of a crisis, contracts are the first thing to be pulled out of the closet and to be read line-by-line to the advantage of each affected party (when it is 'business as usual' and going well, it is likely that no one will read the contract). However, in case of any unexpected event, the same business functions, who were always pressuring to sign the contracts at earliest, will expect from the legal department that the remedy for such an unexpected event should have been provided in the contract. It is therefore always recommended to conduct negotiations with an open mind, because circumstances 'as envisaged at the time of contracting' may not remain same during implementation of such contracts.

I. Force Majeure:

"*Force Majeure*" (FM) is principally identified as being an "exceptional" or "unforeseeable" event or circumstance, beyond any party's control, and something that it could not have reasonably provided against before entering into the contract. Further, such an event cannot be one that the party could have reasonably avoided or overcome, nor is it allowed to be "substantially" attributable to the other party. Typical FM events we commonly find in contracts are war, acts of terrorism, riots or natural calamities like tsunamis or floods. Now, due to COVID-19, events like pandemics and epidemics have also been specifically drafted in.

In simpler terms, FM works like a shock absorber in automobiles and addresses most of the unknown developments which were not known at the time of entering into the contract. It allows a party to not perform its obligations under the contract, for a specified period or to perform those obligations later (once the event has ceased). While in most cases, FM entitles contracting parties to an extension of time in the performance of respective rights, but depending on the nature of the contract, parties may sometimes also agree to provide for cost of such delay and specify whose burden such costs shall be.

For an event to qualify as FM, it must satisfy the above tests and depending on a party's status, i.e. whether a buyer or supplier, a party may propose a close/exclusive or open/inclusive list of FM events. During negotiations, it may look like an overkill to include less-likely events like icing, hail, tsunamis, perils of sea etc., but considering what has transpired now, a party must attempt to include as many events as possible or include suitable catch-all language so that anything that is not in the exhaustive list is caught by this language.

However, even if the FM clause is not detailed enough, if any such event occurs which makes performance of the contract impossible, then one can take shelter of Section 56 of the Indian Contract Act, 1872 which provides for doctrine of 'frustration' and impossibility of performance of the agreement. A word of caution here - one has to carefully consider the impact of invoking this section as it leads to a contract becoming voidable or a termination right kicking in, without the remedy or suspension period remaining available, which is not the case under most FM clauses (where such a remedy or suspension period is available).

There are always some logical exceptions to FM such as labour strikes in a factory, shortage of funds, financial difficulty, normal weather conditions, lack of spare part availability and likewise. Parties can certainly negotiate exceptions to the FM clause, depending on the subject matter of the contract. A FM clause may also require the affected party to take all reasonable steps to minimise the impact of the FM event and upon cessation of such event, resume performance at earliest.

II. Change of Law:

While we all accept that "change is inevitable", it has become very difficult in the current environment to predict "when this change will happen". To plug this gap, one must keep some opportunity of change in every transaction including in the underlying contract. A contract is entered into based on the prevailing laws and rates of taxation. However, during the performance of the contract (especially long-term contracts), laws and taxes may change, thereby altering the risk positions of the parties. Prevailing laws and taxation rates may change, or new general or taxation laws may be promulgated or courts/government authorities may interpret or clarify a particular law in a different manner than what was interpreted at the time of entering into the contract. All these generally qualify as a "change in law", which is a clause usually found in long-term contracts, where the risk of such an event happening is higher. Under such a clause, parties agree that all additional obligations due to any change in law will be at an additional (or mutually agreed) cost. Thus, a detailed clause of "Change in Law" carries a lot of importance, especially for the supplier/contractor/service provider, as in most of the cases all impacts of the change in law are to the owner/principal/buyer's account. In the present situation, if the government comes out with a new law or imposes more taxes to combat the effect of COVID-19, a party may claim the additional cost and also seek an extension of time from the principal on this account, provided that a 'Change in Law' clause was originally agreed in the contract. This clause must therefore be properly drafted and clearly provide for the process and consequences of any kind of change in law.

III. Suspension:

In case of a short-term interruption, a 'suspension' may be more helpful than resorting to a more stringent clause like FM. The suspension clause allows one party to suspend performance of obligations under the contract, usually for specified reasons and for a limited period. This clause also addresses certain exceptions of FM (like strike, shortage of funds, non-receipt of approvals etc.), as generally reasons for suspension are not insisted unless the contract is a time-bound, turnkey or construction contract. In the case of turnkey or capital intensive projects, generally manufacturing activities should not be subject to suspension otherwise all subsequent production slots or 'work in progress' may get adversely impacted, however, activities pertaining to construction/assembling at site may be suspended. Suspension is always for a limited period per incident and subject to a total time period, and before resorting to it, parties must expect to overcome this interruption within a short period. If suspension is declared from the owner's side (e.g. due to non-readiness of site or non-availability of approvals), a contractor shall be entitled for cost and extension of time, however, if a contractor (generally, a contractor does not have suspension rights) declares suspension, he may not get any extension of time and runs the risk of incurring liquidated damages and cost overruns.

IV. Termination:

All the above clauses can be resorted to with one underlying condition – i.e., that work may be resumed later or sooner (of course, within a reasonable period) or may be re-started with a higher negotiated cost. However, if it seems that an event has occurred which makes the project impossible to continue, certain key approvals will not be obtained or costs have escalated by such a margin that it is no longer viable to continue with the project, parties may resort to termination. The termination clause, being an extreme measure in a contract, must be negotiated well and must prescribe well-informed consequences. These consequences may vary substantially depending on the nature of contract – for example, in a supply contract of a consumer product, parties may agree to refund money

and take back the goods. Whereas, in construction or large project contracts, refund of entire monies or heavy termination fee, should not be agreed and instead, parties may agree to get the remaining work done by a third party to the account of the defaulting party and may also agree to a certain termination fee/re-imbursement of costs. None of these consequences should be applicable in the event of a termination arising out of an FM event. Here both parties should walk away with their rights and obligations (including payment) intact, as they existed prior to the trigger of the FM event. The concept of FM presupposes that both parties agree that this is an event beyond either party's control and that this is a risk that they cannot factor into the cost of the contract or indeed in the business. Therefore, in the event the contract is terminated due to an FM event, both parties are exposed to the full risk of the FM event without any protection.

V. Dependencies and Delay Events:

Generally, in a contract, parties are bound to perform certain obligations as per an agreed division of responsibilities or a 'performance schedule' and any delay in performance of one's obligations may delay the performance of other party. Since all projects are time-bound, any delay in completion of the project by the agreed date, makes the contractor or service provider liable to pay liquidated damages for the period of delay, if delay is for reasons attributable to contractor/service provider. However, a situation may occur where a contractor gets delayed due to non-performance of the owner or third parties. As the contractor is not entitled to demand liquidated damages, any such delay (due to owner or third parties) may expose the contractor to overrun of costs and timelines. To address this, a contractor must include a list of such events in the contract which can delay performance of his obligations, due to either non-performance of the other party or occurrence of third-party events. The key difference between such delay events and the rest (like FM) is that contractor does not need to follow a separate process of invoking such an event. Any agreed delay event will then entitle the contractor or service provider to costs and extension of time, plus will not lead to liability of liquidated damages for the contractor. In addition, this will be a key argument for the contractor to use to respond to allegations of contractual breach and threats of termination by the owner/ principal. Depending on the nature and expectation of delays (based on experience and nature of contract), it is recommended to include a detailed 'Delay Events' clause.

The above are only meant to highlight general and key concepts in commercial contracts, in these challenging times. At the same time, as 'one size doesn't fit all', every contract and every eventuality are different. Each negotiation or dispute will be dealt in accordance with the nature of the contract, parties, prevailing circumstances, and other factors. Accordingly, parties while taking guidance from above may finalise contracts as per their own requirements and expectations.

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Please contact us at practicemanager@btg-legal.com if you have any specific questions that we can help you with.

BTG maintains all material on the ongoing COVID-19 crisis and legal implications here. Please click to access.