PSL Advocates & Solicitors

Covid-19 and Commercial Contracts Is Force Majeure Invocation the Panacea or another Pandemic

Introduction

The outbreak of the coronavirus disease 2019 (Covid-19) pandemic has caused widespread disruption of businesses and severely affected commercial supply chains. The pandemic has impacted the ability of businesses around the globe to maintain operations and fulfil existing contractual obligations. As governments across the world struggle to contain the pandemic, unprecedented measures are being implemented aimed at minimizing its spread. In India, such measures include a drastic nationwide lockdown imposed by the Central government for a period of 21 days, which has been extended further in varied degrees nationwide. These measures raise a host of legal issues and concerns for businesses. In general, the pandemic could affect parties' ability to comply with their contractual obligations, or adversely affect their operations. The Covid-19 outbreak also poses additional risks in the form of financial distress or potential insolvency of contracting parties, which may result in automatic termination of business contracts. In this note, we seek to analyze the contractual mechanism of force majeure clauses and how contracting parties may resort to such clauses to pragmatically ameliorate the adverse impact of Covid-19 on their commercial relationships.

What is Force Majeure?

It is important to note that there is no generic definition of force majeure in Common Law. A force majeure clause is a common provision in contracts and widely used as a mechanism for legal risk management in commercial contracts. Simply put, it is a way of allocating the risk of loss if performance under the contract becomes impossible or impracticable, especially as a result of an event that the parties could not have anticipated or controlled. It is an unexpected event that prevents a party from doing or completing something that it had agreed to do.

Generally, a force majeure clause must include the specific event that can allegedly prevent performance under the contract. Parties negotiate which specific events qualify as force majeure events such as, acts of God (*e.g.*, natural disasters or fires), wars, terrorism, riots, labor strikes, embargos, acts of government, epidemics, pandemics, plagues, quarantines, lockdowns and boycotts. If the specific event, such as an epidemic, pandemic or lockdown is included in the force majeure clause and such event occurs during the subsistence of the contract, then the parties may either be relieved from further performance or performance may be temporarily suspended as stipulated.

Depending on their drafting, force majeure clauses may have a variety of stipulated consequences, typically including: excusing the affected party from performing the contract in whole or in part; excusing that party from delay in performance, entitling them to suspend or claim an extension of time for performance; or giving that party a right to terminate. For a counter party, a right of termination and/or suspension could be commercially important,

as it may provide leverage to renegotiate contractual terms in the altered market landscape. Whether a force majeure clause covers an epidemic or pandemic, such as Covid-19, depends largely on the language of the contract and its contextual interpretation.

Force majeure clauses: What must parties bear in mind?

Contracting parties should review their contracts to determine which party bears the risk of loss if performance becomes impossible or impracticable due to an event, especially the Covid-19 pandemic or pursuant government actions such as travel restrictions and lockdown. First, it should be determined whether the contract contains a force majeure clause. Second, it should be determined whether the force majeure clause specifically identifies an epidemic/pandemic, or a similar term, that explicitly excuses or suspends performance under the contract on the happening of such an event. Third, if the clause does not specifically identify an epidemic/pandemic as a force majeure event, it is yet to be determined conclusively whether the clause containing 'act of god' as a force majeure event, would include Covid-19 outbreak or not. Fourth, if the clause does not identify an epidemic, pandemic, lockdown or act of God as a force majeure event, it should be determined whether the clause contains a catch-all phrase that might apply to an epidemic/pandemic.

A catch-all phrase may have similar language to "including, but not limited to." If the force majeure clause contains a catch-all phrase, the courts may apply the principle of contract construction called *ejusdem generis* to include all items of the same class/nature as those listed in force majeure clause but not specifically mentioned therein. Accordingly, if it is determined that Covid-19 pandemic is similar enough to the other events listed in the force majeure clause, it may be considered a force majeure event. However, it is imperative to note that force majeure clauses are not always boilerplate provisions in the contract and can vary significantly across different contracts, based on leverage of the negotiating parties and other factors.

For contracts currently under negotiation, parties must bear in mind that the protection afforded by force majeure clauses for Covid-19 related claims may be quite limited due to issues of foreseeability. Given the inescapable awareness of the Covid-19 outbreak and potential scale of the pandemic today, such claims may be unlikely to satisfy the standard test of foreseeability and may therefore be excluded as a force majeure event. However, parties may agree to claim relief under force majeure clauses in situations where the spread or impact of Covid-19 and the subsequent impact on workforce and supply chains reaches a threshold that is unforeseeable.

Covid-19 outbreak: Whether force majeure can be used as a shield?

A force majeure clause should not be construed as a "free pass" not to perform one's obligations. However, it does offer protection against genuine events that prevent a party from performing its contractual obligations, if the party had no alternate means of performance available. A force majeure clause is generally construed narrowly, and its application will require a demonstration of the impact of an event on the inability to perform contractual obligation(s). Therefore, contracting parties must realise that it may not be commercially prudent or advisable to resort to a force majeure clause on the mere factum of

Covid-19 outbreak, when either the contractual performance remains unaffected or may well be discharged using alternative means, albeit more onerous or expensive.

On 11 March 2020, the World Health Organization announced that Covid-19 can be characterized as a pandemic. Thus, if the force majeure clause specifically refers to epidemics/pandemics (or work stoppages, lay-offs or actions of government including lockdowns and travel restrictions) as events of force majeure, then the clause may be activated by the outbreak of Covid-19 and subsequent events. In India, the 'Ministry of Finance, Department of Expenditure Procurement and Policy Division' issued an internal Office Memorandum dated 19th February 2020, bearing no. F 18/4/2020-PPD, wherein the ministry has recognized Covid-19 as a force majeure event. The Office Memorandum effectively states that the Covid-19 outbreak could be covered by a force majeure clause on the basis that it is a 'natural calamity', caveating that 'due procedure' should be followed by any Government department seeking to invoke it.

It is imperative to note that the said government circular is an internal direction, which may have no direct impact whatsoever upon private commercial understandings and terms of the contracts specifically agreed between parties. However, it may still hold some persuasive value in interpretation of contracts by Indian courts, in instances where force majeure clauses specify 'natural calamities' as a force majeure event. This position is further bolstered by the invocation of the Epidemic Diseases Act, 1897 by different states and union territories the lockdown order under the Disaster Management Act, 2005 by the Central Government.

Contracting parties must consider whether Covid-19 has made performance impossible/fundamentally different or just less convenient and/or more expensive. For example, if the contract requires delivery of goods on a specific date that is now made impossible due to local lockdown measures, that may well be a force majeure event leading to termination of the contract. There must be a genuine failure or likely failure to perform and it must be established that Covid-19 caused the failure to perform a contractual obligation. The simple fact of Covid-19 having spread globally will not be enough to rely on the force majeure provision, if the impact of the outbreak did not actually cause the party's failure to perform the obligations. It must be borne in mind that the onus of proving that the event has prevented performance in manner outlined in the clause lies on the party seeking to avail of the force majeure clause.

A force majeure event must not have been foreseen by the parties. For example, a party seeking to rely on widely drafted and non-specific force majeure clause entered into since the outbreak in China came to light, may find it difficult to convince a judge that the parties did not foresee the risk of Covid-19 impacting the contract. Additionally, a counterparty may try to argue that the Covid-19 outbreak is not unforeseeable, considering the recent SARS outbreak in 2002 as well.

What is the procedure for invoking force majeure clauses?

To fruitfully seek refuge under a force majeure clause, a contracting party must strictly adhere to the modalities and conditions precedent agreed under the contract for such invocation, failing which it may put itself in a precarious legal position subject to interpretational whims. As such, it is advisable that a party seeking to rely on a force majeure clause must firstly

acquaint itself with the procedure envisaged under the contract and comply with any procedural requirements stipulated therein. These may include requirement to give notice of intention to rely on the force majeure clause to the other party within stipulated timeframe, including formalities required for the service of notices in a prescribed mode.

Usually, force majeure clauses also require regular updates to be provided to the counter party about the factual circumstances preventing, hindering or delaying contractual performance. Depending on the precise wording of the force majeure provision, it is for the affected party to demonstrate that an event of force majeure (and not some other factor) delayed performance or caused failure in performance of the contract to establish a cogent causal link between the force majeure event and alleged inability to perform. For often than not, such clauses also carry an express obligation on the affected party to mitigate losses by using best endeavours and reasonable means. Provisions may also specify the extent to which a party declaring force majeure must mitigate, not only the event of force majeure but also its effect.

Change in Law clauses

Apart from a force majeure clause, parties may consider whether there is a change-in-law provision in the contract and the kind of remedies that may be availed by an affected party. Such clauses generally provide for adjustment in price and extension/adjustment in time without a risk of termination if a governmental order or change in applicable law makes contract performance delayed or impracticable or impossible. As discussed above, various national governments have taken drastic measures to curb the menace of Covid-19 outbreak and issued several legislative and executive orders and/or directions, which may have a direct or indirect impact on performance of commercial contracts. In India various lockdown notifications issued by the Government are under the Epidemic Disease Act, 1881 and Disaster Management Act, 2005, which then take the color of 'law'. Further, the Disaster Management Act, 2005 under Section 72 states that the provisions of this act will have overriding effect on other laws. Therefore, the resulting disruption in workforce and materials which are 'directly' impacted due to the notifications passed under the above laws, may be interpreted as a change in law event if the contract provides for a change in law provision and provide for compensation for increased costs due to a change in law or an excuse for performance if a change in law prevents performance. In this context, parties must closely consider as to what will constitute a change in law under the language provided in the contract. Such a clause could be particularly helpful to critical infrastructure businesses and international companies facing increased costs for labor and workforce changes or moving personnel to worksites.

What if there is no force majeure clause: Frustration of contract?

A force majeure clause will not be implied into a contract as a matter of law. Therefore, in the absence of an express force majeure clause, a party could try to claim that the contract has been frustrated. The doctrine of frustration provides that a valid and subsisting contract, which has not yet been fully performed may be discharged where such circumstances arise (1) which were not envisaged at the time the contract was entered into, and (2) which render the contract impossible, illegal and/or impracticable to perform or which transform a party's obligations such that they are radically/fundamentally different to those which the parties originally agreed to perform. The doctrine of frustration is applied narrowly and requires a

very high threshold to be met before it can be established. As such, courts are loathe to declare a contract frustrated and require evidence with high probative value to demonstrate the same.

Under the Indian Contracts Act, 1872 (the "Contract Act"), if a contract becomes impossible or impracticable to perform, parties can avoid contractual obligations either (i) on grounds of contingent supervening events under Section 32 of the Contract Act read with the force majeure clause in the contract, or (ii) on grounds of frustration of the contract under Section 56 of the Contract Act. It is pertinent to note that these two remedies are mutually exclusive and where the contract has expressly (or impliedly) specified a force majeure event, parties cannot rely on such a force majeure event to invoke the doctrine of frustration under the Contract Act.

The Supreme Court of India in **Energy Watchdog v. Central Electricity Regulatory Commission and Anr.2017 (4) SCALE 580***,* held that

> "*In so far as a force majeure event occurs de hors the contract, it is dealt with by a rule of positive law under section 56 of the Contracts Act 1872. The performance of an act as encompassed under the agreement may not be literally impossible, but it may be impracticable and useless from the point of view of the object and purpose of the parties and therefore, cannot be considered as a force majeure event".*

Thus, for proving that a contract has been frustrated by the Covid-19 pandemic, an affected party may need to demonstrate that, not only has there been a supervening impossibility/illegality leading to change in the fundamental objective of the contract as a result of the outbreak, but also that there are no other alternative means of performing the same. Courts in India have time and again held that solely because certain obligations have become onerous or financially burdensome, the contract does not get frustrated. Further, for contracts that have been executed after the outbreak of Covid-19, it may be difficult to prove that the same had not been contemplated by the parties. While the Covid-19 outbreak is affecting a wide array of industries and services around the world, the resultant economic slowdown may not necessarily be considered as a valid event causing frustration of the contract.

If a contract does not contain a provision on *force majeure*, a party invoking the doctrine of frustration must be mindful that when taking a plea under Section 56 of the Contract Act, the contract is automatically discharged. Hence, parties must bear in mind that there is no flexibility of keeping a contract alive or renegotiating the same, as available while invoking a *force majeure* clause. However, parties can recover amounts paid under the contract before it was frustrated less the expenses incurred by the counterparty. This is expressly enacted under Section 65 of the Contract Act. However, this is not an absolute rule and the extent of restitution will depend on several factors, such as expenses incurred by the non-affected party.

What to do when Frustration/Force Majeure claim is made?

As enumerated above, a party must take the following steps when a claim of frustration and/or force majeure is made against it:

- Check whether the contract has a force majeure clause that could cover Covid-19 as a trigger event.
- Check whether there is a causal link between theforce majeure/frustrating event and non-performance of contractual obligation by the affected party.
- Write to the counterparty and request (i) evidence of the circumstances it relies on, (ii) a full explanation of why its performance is now physically/legally impossible, (iii) evidence of steps it is taking to mitigate and (iv) regular updates as to its efforts to resume performance.
- If satisfied with the response, consider entering in a written variation to the contract. If not, consider invoking the dispute resolution mechanism under the contract.

Risks of wrongfully declaring force majeure

It is important to note that if a party invokes force majeure wrongfully in contravention of the contractual terms, it may find that it is in breach of contract. Furthermore, if the invocation of force majeure clause amounts to evidence that the party in question no longer intends to perform the contract, this could amount to a repudiatory breach of contract and the other party may be entitled to claim damages as a result. It is therefore necessary to proceed with caution when relying on a force majeure clause and a party must essentially seek legal counsel before such invocation to avoid the risk of being sued for damages. The principle of awarding damages in such cases is covered under the provisions of the Contract Act and well settled by the Indian courts.

Covid-19 and Bank Guarantees/Letter of Credits

It is worth noting that almost all long-term supply, construction and/or procurement, concession contracts et al. need parties to furnish security for payment as well as performance obligations in the form of bank guarantees and/or letters of credit. The principles and jurisprudence pertaining to invocation of bank guarantees is well settled and the scope of interference of courts is vastly restricted. Bank guarantees or letters of credit constitute a separate contract and the same maybe invoked in accordance with the terms of such contract. As highlighted above, Covid-19 outbreak and subsequent unforeseeable events have severely impacted performance of several contracts. As such, it is germane to discuss the recourse that may be available against invocation of such instruments during this period. The law on the invocation of bank guarantees and exceptions to the said rule are well settled in India. There are two exceptions to the invocation of bank guarantees:

- Fraud; and
- Irretrievable injustice or special equities.

The Hon'ble Supreme Court in **Standard Chartered Bank v. Heavy Engineering Corporation Ltd. and Anr, 2019 SCC OnLine SC 1638** has reiterated the same position setting out that:

> *"23. The settled position in law that emerges from the precedents of this Court is that the bank guarantee is an independent contract between bank and the beneficiary and the bank is always obliged to honour its guarantee as long as it is an unconditional and irrevocable one. The dispute between the beneficiary and the party at whose instance the bank has*

> *given the guarantee is immaterial and is of no consequence. <u>There are, however, exceptions to this Rule when there is a clear case of fraud, irretrievable injustice or special equities.</u> The Court ordinarily should not interfere with the invocation or encashment of the bank guarantee so long as the invocation is in terms of the bank guarantee."*

(Emphasis Supplied)

Although language of stipulated provisions of the guarantee contracts would be paramount, courts would certainly consider the grounds of irretrievable harm or special equities and such contentions must be certain and not speculative in nature while seeking injunctions against invocation of bank guarantees. Considering that the Covid-19 pandemic is an unprecedented event which has caused massive commercial disruptions, it may be formidably argued that the present circumstances are special and that if bank guarantees are invoked for non-performance during such period, the same would result in irretrievable harm to a contracting party. Of course, such pleas would be considered depending on peculiar facts and circumstances of each case.

Some judicial trends

Most recently, the Bombay High Court in the matter of **Standard Retail Pvt. Ltd. v. M/s G.S. Global Corp & Ors., Commercial Arbitration Petition (L) No. 404 of 2020**, gives an insight into the approach that the Courts in India may adopt while dealing with the prevailing situation of Covid-19 outbreak. In this case, the buyer of imported steel sought to restrain the seller from encashing the former's letter of credit on the ground that their contract had been terminated due to frustration, impossibility and impracticability in terms of Section 56 of the Contract Act due to lockdown imposed in the wake of Covid-19 outbreak.

The Court, instead of allowing the reason of lockdown to be an overarching reason for claiming frustration of the contract, examined the nature of the contract in question i.e. a letter of credit and went on to hold that a bank guarantee is a separate contract all-together and is indifferent to the conditions prevailing between the buyer and the seller. Thus, alleged frustration of one contract would not automatically lead to frustration of another contract. Further, in rejecting the relief sought by the buyer, the Court held that commercial hardship could not be cited as a reason to excuse performance to the disadvantage of the seller. In this case, even the force majeure clause in the contract could excuse performance only by the seller and thus, could not come to the aid of the buyer. In any event, where the supply of goods in question and activities connected to it were exempted from the lockdown as an essential service and the lockdown itself was a temporary impediment, if at all, the same cannot be a reason to excuse performance and payment obligations under the contract.

This decision of the Court reaffirms the view that courts would examine the plea of frustration, or even force majeure, on a case-to-case basis depending on the nature of contract and the circumstances between the parties governing it.

Till such time that Indian jurisprudence on whether a pandemic could qualify as a force majeure/frustrating event does not offer clear guidance, foreign jurisprudence may be looked at to get an insight on how the interplay between the two may be interpreted.

The SARS outbreak in 2002 was held to be a force majeure event under the Canadian Law[1]. Even in the United States of America, it has been observed that where one party could not perform its obligations as a result of an epidemic, it could not be held liable for breach of the contract.[2] However, where the outbreak of an epidemic does not significantly change the nature of the outstanding contractual rights or obligations between the parties, it has been held under the law of Hong Kong that the parties cannot be excused from performing their part of the contract for this reason.[3]

Conclusion

Outbreak of Covid-19 as a pandemic and the measures taken globally and locally to combat the same have lead to interruption in performance of various types of contracts, be it for business purposes or otherwise. In either case, if hindrance to the performance is a consequence of the current crises, the parties may find temporary relief under the force majeure clause of the contract or may have the right to assert its termination under the doctrine of frustration under the Contract Act.

In case a party feels that it has been unable to perform on account of Covid-19, it may send an appropriately detailed notice to the other party to the contract seeking for an extension, suspension or renegotiation of the contract. If, however, there is no force majeure clause in the contract or if the same does not envisage force majeure occurrences conclusively or completely and, performance of the contract has become impossible or impracticable, the contract may stand frustrated.

On the other hand, in case a party to a contract is served with a notice for invoking force majeure clause or faced with an allegation that the contract has become frustrated by the other party, the first mentioned party must examine whether the terms of the contract allow the other party to excuse itself from performance in the given circumstances or are alternative mechanisms provided for under the contract which could bar the party from doing so. Even against a plea of frustration raised by a party, the other party may require the first-mentioned party to prove that performance of its obligations have become impossible or impracticable and not merely more onerous. Such an invocation may also be defended on the ground that the difficulty being faced is merely a commercial hardship and not an overpowering force majeure event.

A party seeking to invoke the force majeure clause/doctrine of frustration as well the other party resisting it must analyse whether wrongful invocation of the same would constitute a breach or wrongful termination, thereby making the invoking party liable to pay damages as per the Contract Act.

It is safe to say that globally, the judicial trend is to interpret the clause and doctrine narrowly, and to allow invocation of the same only where the event adversely affects a party's ability to perform its obligations at an intrinsic level and not merely a superficial one.

[1] Canadian Radio-television and Telecommunications Commission in Telecom Decision CRTC 2007-102

[2] Supreme Court of North Dakota in Sandry v. Brooklyn Sch. Dist., 47 N.D. 444

[3] Hong Kong District Court in Li Ching Wing v. Xuan Yi Xiong, [2004] 1 HKLRD 754