Milbank

Client Alert

COVID-19: Impact on Contract Performance from an English Law Perspective

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In managing the volatility and uncertainty caused by the global COVID-19 pandemic, many industries are grappling with complex legal and commercial challenges, from manufacturing shutdowns, interrupted supply chains and quarantines, to dislocated labour markets and restrictions on trade and movement, including the practical shutdown, or near shutdown, of substantial portions of the world economy. Moreover, governments have intervened to provide liquidity and emergency relief to credit markets and vulnerable industries and to preserve payrolls.

Nonetheless, economic uncertainty has forced many companies, lenders and investors to seek guidance on their rights with respect to contractual obligations. This alert provides analysis on some of the key areas of concern regarding contractual performance that have been raised by a range of our clients to date, namely:

- ***force majeure* provisions**
- **material adverse effects provisions**
- **ordinary course of business covenants**
- **the frustration of purpose doctrine**
- **covenants and events of default triggered in finance documents**
- **EBITDA maintenance covenants**

The analysis of any particular contract, transaction or dispute is always fact-specific and depends on, among other things, the specific contract language and conduct of the parties in each instance, as well as the relevant law applicable to that contract, transaction or dispute. Additionally, current market norms continue to evolve and legal rules cannot be interpreted in a vacuum. Regulatory and judicial interpretations of particular contract provisions, duties and applicable law may take those evolving norms into account, especially when determining concepts of materiality, reasonableness, excuse, and ordinary course operations.

As ever, maintaining collaborative commercial relationships and clear communications channels is paramount, beyond the technical interpretation of applicable contract clauses. In these challenging times, parties may receive warnings, *force majeure* notices, or requests for assurance from their contractual counterparties as the COVID-19 public health crisis and market conditions worsen. In such cases, in addition to conducting a contract- and fact-specific analysis, we recommend taking proactive steps, including:

- Briefing personnel who are the primary relationship managers for those counterparties, many of whom will not be lawyers, on the relevant contract doctrines—including those identified below.
- Providing standard documentation and processes to achieve consistent outcomes across large and diverse customer and supplier bases.
- Responding to each communication, particularly those where the counterparty is warning of actual or potential disruption in performance of its obligations. While it is appropriate to acknowledge the existence of COVID-19 and the need for business continuity measures, take care not to waive rights or to diverge from the terms of the underlying contracts without full analysis and proper documentation.
- Proactively contacting critical suppliers and service providers to ask those counterparties to provide information about the business continuity plans that they are executing to maintain continuity of performance.

Even though each situation is unique, the general legal principles that apply when contractual performance is stressed by external shocks are well developed.

I. Force Majeure

- *What is force majeure?*

The concept of *force majeure* (meaning 'superior force' in French) seeks to protect parties to a contract from being held to performance obligations which, due to events outside of their own control and expectation, they cannot fulfil. This civil law derived term has no universally applicable meaning under English law, rather, it is to be assessed on a contract by contract basis, applying normal principles of contractual interpretation / construction.[1]

- *Force majeure events*

A customary *force majeure* clause in a contract will provide contractual relief to a party affected by an event or circumstance which:

(i) is beyond the reasonable control of the affected party;
(ii) is not the result of any act, omission or delay of the affected party;
(iii) could not have been reasonably foreseen, avoided, or reduced by the exercise of reasonable measures; and
(iv) causes or results in that party not being able to perform its obligations (other than the obligation to pay money) under the contract.

The contract will also typically have a non-exhaustive list of events or circumstances that would constitute a *force majeure* event (provided that the above general conditions are satisfied) such as acts of nature (sometimes referred to as acts of God, such as earthquakes, tsunami and epidemics), acts of man (such as war, industrial action, piracy, riot and sabotage) and governmental action (such as change in law, regulations and expropriation). "Disease" or "epidemic" are frequently listed as one of the specific events or circumstances that may constitute *force majeure* (as long as the general requirements of the *force majeure* provision are satisfied), or the COVID-19 outbreak may be caught by a more general term such as "act of God", or simply as an event or circumstance beyond the affected party's reasonable control.

Although this list of events or circumstances is neither exhaustive nor conclusive, it should be noted that the principle of *ejusdem generis* often operates to narrow construction of such a clause when a party is trying to argue that an additional, unlisted event falls within the definition.[2]

To make its claim, the affected party would need to establish that the outbreak is contemplated as a *force majeure* event as an "epidemic" or an "act of God" or, if relevant, that the restrictions placed upon companies and citizens by a government in order to help contain the outbreak, are contemplated by the *force majeure* definition as "governmental action".

Some issues that may be encountered are:

(i) whether the outbreak could have been reasonably foreseen given the precedents for other major epidemics impacting global supplies, including the unrelated SARS outbreak in 2003;
(ii) where the affected party may not have been directly impacted by the outbreak but

[1] In many civil law countries, relief is afforded by statute if the ability of the affected party to perform the contract is prevented or impaired by virtue of specified events beyond its control.

[2] In the *force majeure* context, *ejusdem generis* means that the type of events listed in such a clause will be used as indicators to the court of what else may be impliedly included by a phrase such as "and any other event outside of the Supplier's control". If the event is not of the same category or related to those listed, it may be difficult to argue that it is a *force majeure* event per the contract, as was found in *Tandrin Aviation Holdings Ltd v Aero Toy Store LLC* [2010] EWHC 40.

rather impacted by the subsequent governmental action to contain the outbreak. In this case, the affected party would have to show that governmental action (for which the contractual relief may differ relative to an act of God *force majeure*) constitutes a *force majeure* event; and

(iii) where the affected party is not directly affected by the outbreak but yet is unable to perform an obligation under its contract (the affected contract) because its supplier is claiming *force majeure* due to the outbreak. In this case, the affected party will need to show that the supplier's claim for *force majeure* meets the standards under the affected contract, and that the affected contract expressly allows a *force majeure* claim when the affected party's performance is impacted by a *force majeure* event somewhere else along the supply chain. This is often referred to as 'chain *force majeure*'.

It is worth noting in this regard that the English courts have held that a failure of performance due to the provision of insufficient financial resources, or loss of market due to the event, is unlikely to amount to *force majeure*.[3] Accordingly, a change in economic / market circumstances due to the outbreak affecting the profitability of a contract or the ease with which the parties' obligations can be performed, is perhaps unlikely to be regarded as being a *force majeure* event.

- *Primary and secondary effects*

COVID-19 could be *primarily* relevant to a *force majeure* claim, as where for example key employees (that cannot be reasonably substituted in time) are sick. In practice, in the current circumstances, it may be the *secondary effects* of the pandemic that are the more proximate (and so more clearly relevant) grounds for a valid *force majeure* claim: most especially government recommendations or mandatory restrictions on employees attending the workplace, undertaking necessary travel or (for expatriate employees) entering the country; or perhaps the shutting down of ports or other transportation infrastructure, or perhaps even governmental delays in processing applications for permits etc.

In order to constitute a valid *force majeure* claim, the primary or secondary effects will need to be demonstrated to have "prevented" the non-performance. The language of the contract will be key here: "*prevent performance*" will likely require a standard approaching impossibility, whereas "*prevent or hinder or impede or impair or delay performance*", for example, less so (those such terms may still require performance to be substantially more onerous before relief is available).

- *Contractual Relief*

The contractual relief granted under the contract upon the affected party being able to establish a *force majeure* event will be defined in the contract. Typically, subject to providing notice of the *force majeure* event to the counterparty as prescribed by the contract (often described as an "FM Notice"), such relief involves the suspension of obligations, an extension of the period of time in which to perform obligations, an exclusion from certain liabilities for non-performance or delay, or, for prolonged *force majeure* events, termination of the contract.

The basic consequence of a valid claim under a *force majeure* clause is that a non-performing party will not be held to be in breach of contract for its non-performance due to the *force majeure*, and so will be excused of any potential liability in damages for such non-performance.

The type of relief granted under the contract will depend on which performance obligations are being prevented, and why. If the outbreak is causing a temporary period of disruption whilst the party adapts, relief may be a short suspensory period. In contrast, long-term prevention of performance may be met by termination of the contract.

[3] *Tandrin Aviation Holdings Ltd v Aero Toy Store LLC* [2010] EWHC 40.

It should also be noted that the solutions, remedies and cures associated with the event often differ depending on the categorisation of that event. For example, the consequences under a contract in relation to governmental action/political *force majeure* can differ significantly from those arising from an "act of God" *force majeure*.

- *Duty to mitigate*

A duty to mitigate the effects of a *force majeure* event is customarily expressly included in a *force majeure* clause. This clause may require the taking of steps that a reasonable and prudent operator may require an affected party to take in order to (i) overcome the relevant *force majeure* event and in order to resume full performance of its obligation, and (ii) minimise the effects of such *force majeure* event.

Consider also what requirements are imposed on the affected party to mitigate the impeded performance by exploring alternative means to perform: generally we can expect that a *force majeure* claim is likely to succeed only where significant efforts have been made to exhaust alternative possibilities of performance, including through other supply sources, transportation routes etc. Mere increased costs of alternative performance (except perhaps in extreme cases) are unlikely to provide sufficient excuse for failing to take such steps. Similarly, lack of funds or lack of a market to profitably on-sell into are unlikely to provide grounds for *force majeure* relief (even if not expressly excluded, and such matters are customarily excluded) – though conceivably insolvency of key suppliers or physical constraints of in market (e.g., lack of ullage in an storage facility or pipeline) could provide valid grounds if they constituted secondary effects of the *force majeure.*

The English courts have emphasised that reasonable endeavours/mitigation obligations impose a significant burden on a party seeking to rely upon a *force majeure* clause. In particular, the relying party must take into consideration not only its own commercial interests but also those of the other party when deciding what steps it can and should take to avoid or mitigate the effects of a *force majeure* event.[4]

- *Practical Considerations*

If there is any potential of making a *force majeure* claim under a contract, as well as a very specific consideration of the exact wording of the *force majeure* provisions to ascertain its applicability with legal counsel, the following should also be diligently attended to:

(i) Importance of paper trails – the burden of proof is on the person claiming *force majeure* relief. It is that party who will need to "prove" (or demonstrate on a balance or probabilities) that their performance was affected by *force majeure* to the extent required and within the scope of the provisions, and that they satisfied the requirements to take steps to mitigate the *force majeure*. An affected party will therefore wish to carefully preserve evidence (including paper trails) relating both the extent to which their performance was prevented and the measures that they took to mitigate its effects (both internally, such as provision for remote working; and externally, such as seeking alternative supply sources or means or transport etc.).

(ii) Timely notice to counterparties – there may be strict requirements to notify counterparties of the potential or materialisation of a *force majeure* event, either promptly on becoming aware or within a specified time window. Adherence to these notice requirements may be a condition of being able to make a successful *force majeure* claim. However, inadvertently making a premature *force majeure* claim may also be a risk: pursuant to the contract terms this may relieve the counterparty of its corresponding obligations or permit the counterparty to source an alternative supply or market. The notice provisions should therefore be studied very carefully.

(iii) Notices to lenders – the occurrence of a *force majeure* event by a borrower or counterparty will typically give rise to notice requirements under finance documents (especially in a project financing context), which much be strictly complied with to

[4] *Tullow Ghana Limited v Seadrill Ghana Operations Limited* [2018] EWHC 1640 (Comm).

avoid breach of covenant and potential Events of Default.

(iv) If a *force majeure* claim is formally referred to dispute resolution, the scope of the clause and factual evidence will be scrutinised by the courts or arbitral tribunals as applicable. As a very general comment, common law jurisdictions have been perceived as reluctant to allow *force majeure* relief lightly (as they are reluctant to allow a broad application to any clause that effectively limits liability) – and this can lead to narrow construction of clauses where there is ambiguity as well as the requirement for relatively high thresholds of evidence of factual circumstances and mitigation efforts. New York law has been perceived as even stricter in this regard then English law. Accordingly, making a *force majeure* claim should clearly not be undertaken lightly – and similarly if receiving a *force majeure* claim it would be weighed up against that standard.

(v) The commercial reality is that the *force majeure* will be taking place in the context of a commercial relationship between two parties and further within the context of a specific trade or industry. Regardless as to what the contract and *force majeure* provisions provide, the dynamics of such relationships and context will have their own imperatives. Therefore, as well as having a clear analysis of the contractual provisions and being scrupulous in adhering to notice requirements, mitigation requirements and the preservation of evidence, parties will wish to consider also their commercial relationships, opportunities and reputations.

II. Material Adverse Effects

Complex contracts often contain a provision allowing termination of the contract, or relief from certain obligations, in the event of a "material adverse effect" or "material adverse change" ("MAE") on the business of one of the parties. Generally speaking, MAE provisions protect a party to a contract from performance when there has been an effect, change, event, or occurrence that, individually or in the aggregate, has had or would reasonably be expected to have a materially adverse effect on the other party. Exact formulations of the provision will differ from contract to contract and across contract types (*e.g.*, MAEs in merger agreements may be different than in credit agreements).

An assessment of a party's rights to invoke the MAE clause requires a close review of the context of a contract—*i.e.*, is the contract for an M&A deal, financing, etc.—as well as the contractual language at issue.

MAE clauses typically do not define "material," with parties instead preferring to negotiate exceptions (and exclusions from exceptions) that allocate categories of MAE risk. As a result, courts look to duration, magnitude, and foreseeability of the adverse event in determining materiality. What is durationally significant depends on the context of the contract. The length of durationally significant events for potential acquisitions can differ significantly from the length of a durationally significant event for a short-term loan. Finally, absent a specific provision to the contrary, it is generally understood that a party to a contract cannot terminate the contract based on an adverse fact that it knew about at the time it entered into the contract.

MAE clauses typically contemplate four general categories of risk: systematic or market-wide risks, indicator risks, agreement risks, and business risks. In the M&A context, the typical MAE clause allocates general market or industry risk to the buyer, and company-specific risks to the seller. COVID-19 most likely should be considered an industry-wide risk.

- *What counts as an MAE?*

  What counts as an MAE is a product of the particular contract at issue. An MAE is generally understood as an unforeseen, durationally significant change that substantially threatens the overall financial performance of a party to the contract. What is a durationally significant period depends based on type of contract (e.g. in financing—where the lender is looking at a borrower's short-term ability to make payments on the loan—or a licensing). In industries where earnings are affected by seasonality, courts generally compare year-over-year periods rather than the prior quarter.

- *Is COVID-19 an MAE?*

  Whether COVID-19 or the governmental action taken to contain COVID-19 are within the

scope of an MAE clause will depend on two primary factors: whether those events are listed in or carved out from the clause (or are events of the same type as events listed in or carved out from the clause); and the duration and scope of the pandemic and resulting governmental restrictions, including general quarantines and stay-at-home orders.

Commonly, MAE provisions start with a general statement of what constitutes an MAE, and then move on to carve out certain types of events that otherwise could give rise to an MAE.

Additionally, we do not yet know the duration of the pandemic or the resulting government restrictions and stay-at-home orders. Some jurisdictions have cancelled or relaxed previously pending stay-at-home orders only to reinstitute them. By the time a party's reliance on an MAE clause to nullify performance is fully litigated, a court may have the benefit of hindsight to determine whether COVID-19 is an MAE.

- *Does economic hardship provide enough basis to exercise an MAE clause?*

  Unexpected economic hardship is the basis of MAE clauses, subject to specifically negotiated carve-outs and assignment of risk in a contract. However, the economic hardship must be both durationally significant and of significant magnitude. One important question is whether, and to what extent, the at-issue MAE clause contains any forward-looking language like "would", "could", or "prospects of the party". Forward-looking language in an MAE clause could allow a party to more readily invoke the clause based on future, expected losses from the COVID 19-related downturn, not just the already-realised losses that are properly booked now per the applicable accounting standards.

  COVID-19 and the downstream economic consequences are a rapidly evolving situation and forward-looking estimates of performance are volatile. The context of a party's business, the contract, and the ever-evolving context of the health risks and governmental restrictions will help define whether a party's economic hardship due to COVID-19 qualifies as durationally significant and of a material magnitude to qualify as an MAE.

- *Is a party able to exercise an MAE clause in a contract executed after the discovery of COVID-19?*

  This, like other MAE questions, is a highly factual question that may depend on when and where the contract was executed. COVID-19 was first reported in Wuhan, China in December 2019, and information regarding spread of the disease, health risks, and downstream economic consequences has been rapidly evolving ever since. Whether the parties to a contract were able to foresee the downstream economic consequences of COVID-19 likely depends on time of contract execution, place of performance, and location of a party's business operations. Parties that executed contracts to be performed in the United States or Europe in January 2020 would be able to put forth a more compelling lack-of-foreseeability argument than parties to a contract in China in January 2020 or parties executing a contract in New York or London now.

III. Ordinary Course of Business

Many contracts typically contain a covenant that requires parties to operate their and their subsidiaries' businesses in the "ordinary course of business" during the term of the contract. Absent the relevant contract defining ordinary course of business, the key inquiry in whether a company is operating in the ordinary course of business is whether a disputed practice is consistent with the company's past practices that pre- date the merger or acquisition. If a disputed practice was in place prior to the execution of the "ordinary course" covenant, courts generally find that the practice is within the ordinary course of business.

- *Are actions taken in response to COVID-19 potential breaches of this covenant?*

  While the contractual language is likely to govern, ordinary course of business covenants

may be flexible considering the COVID-19 crisis. Some ordinary course covenants will provide that parties are required to undertake to comply with the covenant with "best efforts," "reasonable efforts," "commercially reasonable efforts," "good faith efforts," or another standard of conduct. If included, standard of conduct language in connection with the ordinary course covenant will shed some light on what a business is required to do. That said, some jurisdictions may find little difference among various standards of conduct.

Absent standard-of-conduct language in the ordinary course covenant, courts may still allow parties flexibility when considering whether they acted in the ordinary course of business. Depending on the jurisdiction, non-routine business operations are not *per se* outside the ordinary course of business if there are compelling business reasons for such a non-routine operation. Parties will be safest if they can analogise current practices that are responsive to the COVID-19 crisis to past practices taken in the ordinary course.

IV. Frustration

In the absence of a force majeure clause which covers the event in question, a party may seek to rely on the common law doctrine of frustration.[5] There is no separate doctrine of impossibility or impracticability (as there is, for example, under New York law).

Under English law, a contract may automatically be terminated on the basis of frustration when an event 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.[6] The event must be beyond the reasonable control of the parties and not the result of either party's fault.[7]

Where a contract has been frustrated (in line with the above principles), then the parties will have no further obligations under its terms.

Due to the drastic consequences of this doctrine, the English courts have tended to interpret frustrating events narrowly, as "*the courts do not wish to allow a party to appeal to the doctrine of frustration in an effort to escape from what has proved to be a bad bargain: frustration is "not lightly to be invoked to relieve contracting parties of the normal consequences of imprudent commercial bargains".*"[8]

- *What kind of event is required for a claim of frustration to succeed?*

  As set out above, given the high threshold to be met in order to prove that such events indeed operated so as to frustrate a contract, courts are generally hesitant to deem supervening events as acts of frustration. However, contracts have been held to be frustrated, *inter alia*, in the following types of circumstances:

  - Impossibility (as a result of the destruction or unavailability of the subject matter or purpose of the contract);
  - Performance becoming radically different from the method of performance contemplated at the time of entry into the contract; and
  - Supervening illegality/change in law.

We set out below certain key points in relation to (i) impossibility, (ii) radically different performance and (iii) illegality, drawing on decided authorities. However, it is important to bear in mind that the application of the doctrine of frustration will, in each case, depend on the interpretation of the specific obligations set out in the particular contract in question, together with the underlying factual circumstances in play.

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[5] An express force majeure provision in the contract which covers the allegedly frustrating event will generally preclude the application of the doctrine of frustration in respect of the event. (see, for example, *Joseph Constantine S.S. Line Ltd v Imperial Smelting Corp Ltd* [1942] A.C. 154, 163).

[6] *Chitty on Contracts*, 33rd Edition, 23-001.

[7] As Lord Radcliffe noted in *Davis Contractors Ltd v Fareham UDC* [1956] AC 696: "*frustration occurs whenever the law recognises that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract. Non haec in foedera veni. It was not this that I promised to do.*"

[8] *Chitty on Contracts*, 33rd Edition, 23-003.

- *Impossibility*

  Frustration may occur as a result of the impossibility of the agreed performance and/or agreed purpose of a contract.

  For example, in *Poussard v Spiers and Pond*, an opera singer was unable to perform on the opening night pursuant to her contract with the opera company due to illness.[9] The contract was held to have been frustrated, as the singer's inability to perform was at the root of the contract.

  However, impossibility (especially in relation to the purpose of the contract) is not necessarily sufficient. In *Herne Bay Steamboat Co v Hutton*, for example, a steamboat was hired to view the Naval Review at Spithead and "*for a day's cruise around the fleet*". Despite the Naval Review being cancelled, the Court held that it was still possible to use the vessel "*for a day's cruise around the fleet*", and, therefore, there had not been a complete failure of the fundamental purpose of the contract.[10]

  The ability to perform the contract by some other (not fundamentally different) method is also likely to defeat a claim that the contract has been frustrated.[11] As further explained in *CTI Group Inc v Transclear SA (The Mary Nour)*, "*it is important to recognise that a contract would not necessarily be frustrated simply because performance had become impossible… and that it would not be frustrated simply because one party was prevented from performing in the manner originally intended if performance in some other manner was possible*"[12] We consider this further below, in relation to radically different performance.

  If it is still possible to perform certain parts of the contract, the courts may take the view that the contract continues as regards those obligations. See, for example*, Errington v Aynsly*, where, despite it proving impossible to lay the foundations for a bridge pursuant to a contract to build that bridge, the court ordered that the bridge be built on the nearest possible site and that compensation be paid.[13]

  As the consideration of these matters is necessarily fact - and case - specific, factors such as the degree or the length of the impossibility vis-à-vis the length of the contractual term will also be relevant.

- *Radically different performance from that contemplated at the time of the contract*

  A leading authority in relation to such circumstances is the case of *Tsakiroglou & Co Ltd v Noblee Thorl GmbH.*[14] In this case, the House of Lords considered whether transporting goods via the Cape of Good Hope – in circumstances where the customary route via the Suez Canal was impossible due to the canal's closure in November 1956 - was within the 'range' of the contract or, alternatively, was so radically different that it left that contract frustrated. The House of Lords held that the contract would not be frustrated in these circumstances, because a reasonable route (even one which would take three times longer) was still available.[15]

  See also *The Furness Bridge*, where, despite an embargo having been imposed by Libya on oil shipments to the US and the Caribbean, the Court found that there were still commercially available options to ship oil via non-Libyan ports.[16]

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[9] (1876) 1 QBD 410.

[10] [1903] 2 K.B. 683.

[11] See, for example, *Seabridge Shipping Ltd v Antco Shipping Co (The Furness Bridge)* [1977] 5 WLUK 31.

[12] [2008] EWCA Civ 856; *J Lauritzen AS v Wijsmuller BV (The Super Servant Two)* [1990] 1 Lloyd's Rep. 1 considered.

[13] (1788) 2 Bro CC 340.

[14] [1962] A.C. 93.

[15] However, in this case, the goods were not perishable and a date for their delivery had not been fixed. If one or both of these factors had applied, the contract might have been frustrated.

[16] [1977] 2 Lloyd's Rep 367.

Similarly, Lord Reid stated in *Davis Contractors v Fareham Urban DC* that "[t]*he question is whether the contract which they did make is, on its true construction, wide enough to apply to the new situation: if it is not, then it is at an end.*"[17]

- *Illegality*

If performance of an English-law governed contract becomes illegal as a matter of English law, then that contract will be discharged. In the case of *Baily v De Crespigny,* a lessor was held not to be liable for an alleged breach of a covenant not to build on a piece of land, because a station that was built on that land was done by way of a compulsory acquisition through statute.[18]

Wartime cases have historically helped to illustrate when supervening legal changes result in performance of a contract becoming illegal, and thus when the doctrine of frustration might apply. In such cases, it has been held that the relevant act of frustration must be "… *of such a character and duration that it vitally and fundamentally changed the conditions of the contract, and could not possibly have been in the contemplation of the parties to the contract when it was made".*[19]

See, by contrast, *Mertens v Home Freeholds Co,* where deliberate delay by a builder, despite the relevant work being subsequently stopped by a Government ministry, meant that the doctrine of frustration did not apply and did not relieve the builder was performance.[20]

As stated above, the threshold to be met is a high one – mere difficulty or inconvenience is not sufficient. The performance of the contract must be prohibited (see, for example, *Waugh v Morris,* where, despite a ship being prevented from unloading cargo by authorities due to fears of a disease spreading from France to England, the Court found that "*the performance by receiving the cargo alongside in the river without landing it at all was both legal and practicable*.") [21]

In general, the fact that performance of a contract would be illegal pursuant to the laws of another country will not affect the validity of that contract as a matter of English law.[22] However, there are exceptions to this general rule. For example, if the English contract is to be performed abroad, and that performance becomes illegal by the law of the place of performance, the contract will not, as a matter of common law, be enforced in England.[23] [24]

Consideration must also be given as to whether article 9 of Rome I applies (relating to overriding mandatory provisions), and whether the illegality in question relates to the law of the place of performance, the law of the forum or the governing law of the contract.

- *What might a typical, potential act of frustration be in the COVID-19 context?*

A party might assert frustration for its non-performance if COVID- 19 were to destroy or render impossible the subject matter or commercial purpose of the contract (as contemplated at the time of entering into the contract).

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[17] [1956] A.C. 696. See also, more recently, *Canary Wharf (BP4) T1 Limited & ors v European Medicines Agency* [2019] EWHC 335 (Ch).

[18] (1868-69) L.R. 4 Q.B. 180.

[19] Metropolitan Water Board v. Dick, Kerr & Co., Ltd(1) [1918] A.C. 119.

[20] [1921] 2 KB 526, CA.

[21] (1872-3) LR 8 QB 202.

[22] *Chitty on Contracts*, 23-027.

[23] *Ralli Bros v Compania Naviera Sota y Aznar* [1920] 2 K.B. 287. This case related to legislative acts (as opposed to executive acts).

[24] However, such a contract will not be frustrated where the law of the place of performance merely excuses a party from full performance (as opposed to making that performance illegal). *Chitty on Contracts*, 23-027. See also *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] and *Melli Bank v Holbud Ltd* [2013] EWHC 1506 (Comm), where, in relation to sanctions, courts have been hesitant to declare contracts frustrated in such circumstances (if, for example, a licence could have been sought).

In the context of the COVID-19 pandemic, examples of situations which (absent an express force majeure clause) *might* engage the doctrine of frustration could potentially include the following:

- A travel ban preventing a contract for freight services from being fulfilled (assuming there is no alternative way to perform the contract, or no alternative way which is not fundamentally different from the means which has become impossible).
- A Government imposed flight ban rendering performance of a contract for aircraft services illegal.
- A person who is essential for the performance of the contract becoming unavailable, for example as a result of temporary self-isolation or incapacity due to the pandemic.

- *Can a party assert frustration where unforeseen events have made performance more financially burdensome?*

  Generally speaking, no. The fact that a contract is merely more expensive to perform will not give rise to a frustration defence. See, as above, *Tsakiroglou & Co Ltd v Noblee Thorl GmbH*, where the Court made clear that "*it hardly needs reasserting that an increase of expense is not a ground of frustration*."[25]

- *What constitutes "destruction" of the means of performance?*

  In *Taylor v Caldwell*, a concert hall was destroyed by fire. The judge held that: "*this destruction, we must take it on the evidence, was without the fault of either party, and was so complete that in consequence the concerts could not be given as intended… the destruction of the person or thing shall excuse the performance; but that excuse is by law implied, because from the nature of the contract it is apparent that the parties contracted on the basis of the continued existence of the particular person or chattel*".[26]

  Impossibility or unavailability of the subject matter/commercial purpose of the contract may also be relevant in this context (see the analysis above).[27]

- *Could a governmental order to close non-essential businesses excuse performance by impossibility?*

  Possibly. See above the analysis in relation to impossibility and/or illegality. A party could potentially invoke the doctrine of frustration if it were forced to suspend operations pursuant to a stay-at-home order, directing non-essential businesses to cease in-office operations.

  However, if a party can rely on business operations in another jurisdiction or provide goods/services via an alternative method and/or supplier (even if more expensive), frustration arguments would likely fail. Similarly, if such an order were temporary, it might not render performance legally impossible unless, for example, the time of performance was an essential element of the contract.

  Any delay must generally be abnormal (whether by its cause, effects or duration) in order to engage the doctrine of frustration. See also *Pioneer Shipping Ltd v B.T.P. Tioxide Ltd (The Nema)*: *"… it is often necessary to wait upon events in order to see whether the delay already suffered and the prospects of further delay from that cause, will make any ultimate performance of the relevant contractual obligations 'radically different'… from that which was undertaken by the contract. But, as has often been said, businessmen must not be required to await events too long. They are entitled to know where they stand. Whether or not the*

[25] [1962] A.C. 93.

[26] 122 E.R. 309; similarly, in *Appleby v Myers* (1866-67) L.R. 2 C.P. 651, the Court held that "*where, as in the present case, the premises are destroyed without fault on either side, it is a misfortune equally affecting both parties; excusing both from further performance of the contract, but giving a cause of action to neither*."

[27] See also *Jackson v Union Marine Insurance Co Ltd* (1874) 10 Common Pleas 125, for example, where the Court held that a contract had been frustrated, as "*a voyage undertaken after the ship was sufficiently repaired would have been a different voyage … different as a different adventure*".

delay is such as to bring about frustration must be a question to be determined by an informed judgment based upon all the evidence of what has occurred and what is likely thereafter to occur. Often it will be a question of degree whether the effect of delay suffered, and likely to be suffered, will be such as to bring about frustration of the particular adventure in question."[28]

- *Can a party invoke impossibility or impracticability of another's performance—for example, a key supplier's—to avoid its own?*

  Generally, no. The fact that a supplier cannot make goods available for shipment, thus rendering performance by the seller impossible, has been held not to be (of itself) sufficient, in the circumstances, to frustrate a contract (see *CTI Group Inc v Transclear SA)*.[29] The seller is normally held to assume the risk of goods not being supplied per the contemplated arrangements of the contract. If there are alternative means of obtaining supplies, this will also weigh against a contract being deemed frustrated.

V. Covenants and Event of Defaults Triggered Under Finance Documents

The coronavirus outbreak may have an impact on a variety of obligations contained in typical finance documents, and it is important for borrowers and lenders to be aware of these.

- **Financial covenants:** if a party faces financial problems due to the outbreak and its consequences, financial covenants and payment obligations may be breached, and such issues should be identified as soon as possible in order for a mitigation strategy to be developed.
- **Information covenants:** certain information covenants (for example, a covenant to notify the lenders of a *force majeure* event that could reasonably be expected to have a material adverse effect on the borrower's business) may be triggered by the outbreak and/or its consequences, and these obligations are often subject to certain time limits.
- **Events of default:** unless there is a carve-out for *force majeure*, a suspension or abandonment of a project as a consequence of the outbreak may constitute an event of default under the finance documents.
- **Material Adverse Change:** it is possible that the outbreak and its consequences result in a "Material Adverse Change" (where the borrower's financial and/or business condition or ability to comply with its contractual obligations under key transaction documents could be materially adversely affected) for the purposes of representations and warranties or any associated event of default under the finance documents.

VI. Maintenance of EBITDA Covenants

Generally, borrowers must comply with maintenance covenants that test net debt to EBITDA or adjusted EBITDA. COVID-19 may affect a borrower's compliance with those covenants either due to reduced revenue or increased expenses related to pivoting to complying with stay-at-home orders or other government-imposed restrictions. Maintenance covenants that test for net debt to adjusted EBITDA often allow for add-backs along the lines of "*any items classified by the company as extraordinary, one-off, one time, exceptional, unusual or non-recurring*." COVID-19 may constitute a one-off, exceptional, non-recurring event. Certain COVID 19-related expenses likely can be added back, but the extent to which a borrower may do so likely will be litigated in the near-future, and it is unclear how these add-backs will be construed. Construction of maintenance covenants will be highly dependent on the nuances of each contract's covenants.

- *What expenses can be added back to adjusted EBITDA as "one-time" expenses?*

  Some COVID-19 expenses likely may be added back, but the scope of what can be added back likely will be the subject of negotiations or litigation. For example, a borrower may have a good argument to add-back expenses associated with deep cleaning of offices and

[28] [1981] 3 W.L.R. 292.
[29] [2008] EWCA Civ 856.

lost deposits on conference centre bookings but may face more difficult challenges in adding back general revenue losses from COVID-19 because those losses are hard to quantify.

Going forward, it will be important to have precise language concerning COVID-19 in new financing transactions. Some parties have suggested including new language with broad grants for addbacks that would cover all COVID 19-related losses, further indicating that general revenue losses likely cannot be added back under the typical expense add-back language. In drafting new financing arrangements, lenders should be careful to limit COVID-19-related add-backs to actual costs incurred or to negotiate a cap on general revenue loss add-backs.

- *How will courts and regulatory authorities interpret existing maintenance covenants?*

  Courts may resist harshly interpreting or applying maintenance covenants—despite clear contractual language—given the scope of the COVID-19 public health crisis. For example, United Kingdom banking regulators issued a release on March 26, 2020, indicating lenders should tend toward lenience for COVID-19-related disruptions: "[R]isk management takes into account fully the differences between 'normal' covenant breaches and some of the breaches that might occur because of the Covid-19 pandemic." As such, lenders should be careful in enforcing maintenance covenants strictly and should resolve issues through negotiation with the borrower if possible.

- *How should lenders approach enforcement of maintenance covenants?*

  Maintenance covenants are designed as an early warning sign for lenders and do not necessarily require enforcement of the covenant. However, COVID-19 itself serves as the early warning sign in this instance rather than in other deals where the underperformance is due to less clear reasons. Lenders should assess whether covenant breaches are connected short-term disruptions that businesses will recover from, particularly when a borrower's management team would prefer to mitigate the disruption rather than spending additional time negotiating with lenders. Lenders should also consider their placement within the borrower's capital structure (either as super senior on collateral, or closer to the assets) and whether that will allow for added patience through the more difficult period for the borrower.

- *How should borrowers handle "springing" covenants?*

  "Springing" covenants are maintenance covenants that are only tested when the drawing threshold is met. One option is that borrowers can manage cashflows to only draw upon a facility after the covenant testing date, which will defer covenant testing for a full quarter. This is a risky approach, especially if the COVID-19 pandemic and stay-at-home orders end up worse than currently expected, but this approach could allow for additional liquidity at a time when the company has a more immediate requirement.

The above areas are complicated, integrated issues that may evolve as we receive updates about the spread of COVID-19 and the governmental response. Milbank is continuing to monitor developments in real-time from courts, regulators, and the business world. Clients are encouraged to contact Milbank with any questions about the above or any other COVID-related issues.

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