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Contracts & Compliance: Business Integrity in the face of Adversity

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Contracts & Compliance: Business Integrity in the face of Adversity

Understanding legalities and compliance in a world where conditions are less than ideal and Force Majeure has a new definition

By President's Counsel Kuvera de Zoysa

Introduction

The novel coronavirus, Covid-19, was declared a global pandemic by the WHO on the 11th of March 2020. The impact on the global economy during the months leading up to and following the crisis, are unprecedented.

As the world familiarises itself with the "new normal", affected businesses and people alike are wary of new investments. A global crisis such as Covid-19 does not discriminate. It affects all; from first world to developing countries, from blue chip companies to home businesses, the economic and social impact of the pandemic has resulted in a lack of confidence and an overall disinclination towards risk taking.

Performance of Contracts during a Global Crisis

The cornerstone of any new dealing is a legally binding contract. Businesses and persons all over the world are skeptical when entering into new contracts for fear that they may be unable to enforce the contract and/or perform their obligations under the contract. Similarly, parties who have already entered into agreements are often left with no redress when such agreements are dishonoured. This skepticism is one of the biggest hindrances to economic recovery and growth following any national or global crisis.

Relief Available to a Contracting Party

Although the economic fallout following a global crisis is itself "global", the relief available to a contracting party depends mainly on the law governing the contract. The main concern of any party to a contract in current times is whether they would be entitled to any relief in the event of default by the other party. Conversely, parties may be concerned as to their own liability in the event they are the defaulting party. Most international agreements will specify the law governing the agreement and may even make provision for alternate dispute resolution in the event its terms are not honoured.

The law on contracts in Sri Lanka is governed by English and Roman Dutch Law. Although the English law on this area has changed overtime, there are fundamental differences in the approach to "impossibility of performance of contracts" between English and Roman Dutch Law. Thus, the consequences of failure of performance due to impossibility will depend substantially, if not wholly, on the applicable law.

A Sri Lankan Perspective - English Law vs. Roman Dutch Law

There are fundamental differences in the approach to the question of impossibility of performance of contracts in English Law and Roman Dutch Law. These differences, once having been poignant, have now through a long process of ever-changing law, been almost wiped out, as the English Law on this area has developed to be almost in line the Roman Dutch Law.

Roman Dutch Law - Incorporation of an Implied Condition

"Unless it can be shown that either English Law, or statute law, or one of the systems of personal law governs the matter at hand, the law to be applied in matters of contract would be the Roman Dutch Law."
~ C. G. Weeramantry, The Law of Contracts ~

According to the Roman Dutch Law, an implied condition is incorporated into the contract to the effect that performance is expected only if performance is possible, unless the parties have contracted otherwise. In other words, there is a presumption that the contract is subject to an implied condition that **impossibility operates as discharge**, unless the parties have contracted otherwise.

This implication covers situations where the impossibility of performance is due to *vis major* or *casus fortuitous* (all direct acts of nature, unforeseen violence).

What constitutes a supervening impossibility?

- When the subject matter of the contract is destroyed.

  The subject matter, in this instance, need not be completely destroyed. What is envisaged is a substantial destruction of the property to such an extent that it is no longer the property that the parties intended when they entered into the agreement.

- When the state of things that was the foundation of the contract has ceased to exist.

- When performance becomes legally impossible.

In *Alibhoy v The Ceylon Wharfage* 56 NLR 470 it was held, that the term "*vis major*" is not limited to an act of God or piracy, shipwreck, thunder or war. It is sufficient for the carrier to refute the initial presumption of negligence by proving that the loss of goods resulted from some cause that was "utterly beyond his power to prevent".

In *Punchisingho v de Silva* 38 NLR 416 it was held that a tenant is entitled to remission of rent either wholly or in part where he has been prevented either entirely or to a considerable extent from making use of the property for the purposes for which it was let, by some *vis major* or *casus fortuitus*, provided always that the loss of enjoyment of the property is the direct and immediate result of the *vis major* or *casus fortuitus*, and is not merely indirectly or remotely connected therewith.

In *Hersman v Shapiro* 1926 TPD 367 it was held, that a court will consider "the nature of the contract, the relation of the parties, the circumstances of the case and the nature of the impossibility invoked" in determining whether the contract in question could be discharged on the basis of supervening impossibility.

Limits to the doctrine

The *vis major* must render the performance of the contract impossible, not simply inconvenient or more expensive. Furthermore, the impossibility of performance must not be due to the fault of the party pleading impossibility.

In *Abdul Latiff v Ceylon Wharfage* 61 NLR 169 it was held, that a defence of *vis major* should not be upheld save on the clearest evidence.

English Law - Absolute Duty of Performance

According to English Law, there is no presumption of an implied condition incorporated into the contract. A party who wants to free himself of his obligations in the event of impossibility of performance must expressly include a condition in the contract to the effect that his liability would depend on the possibility of continued performance.

Although the English Law has stayed true to this fundamental principle, there is a long line of exceptions developed through case law where English courts have found a supposed "intention" of the parties not to create absolute duties of performance.

> In *Paradine v Jane* 1647 EWHC KB J5 the principle of "absolute liability" was illustrated. It was held, that "when a party by his own contract creates a duty or charge upon himself, he is bound to make it good, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract."

The English Law recognises the doctrine of frustration as a method of discharge of contract.

> In *Davis Contractors Ltd. v Fareham UDC* 1956 AC 696 it was held, that "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 … It was not this that I promised to do".

Situations where frustration has been successfully pleaded

- Destruction of subject matter

  Taylor v Caldwell 1863 3 B&S 826 - If something central to the performance of the contract no longer exists, then the courts will find that the parties' obligations should come to an end. However, full destruction of the property may not be necessary.

  In *Asfar v Blundell* 1896 1 QB 123 it was held, that the contamination of perishable goods, which rendered them unusable, was held to be equivalent to destruction.

- Personal incapacity

  Where parties have agreed that the contractual duties are to be carried out by a particular person, and that person dies or is too ill to perform; *Condor v Baron Knights* 1966 1 WLR 87

  However, the performance of the obligations must be specifically by such person. If the identity of the person performing the contract is immaterial, the doctrine of frustration will not apply.

The court will need to be satisfied, however, that the contract was not simply for work to be done, but for it to be done by the particular individual who is unavailable; *Robinson v Davison* 1871 LR 6 Ex 269

- Non-occurrence of an event that the contract was founded upon

In *Krell v Henry* 1903 2 KB 740 where a room overlooking the route of the coronation procession had been hired for the purpose of watching it and the procession was cancelled, it was held that, the contract for the hire of the room was frustrated.

It is important to be clear as to the precise obligations under the contract in order to decide whether a cancellation has this effect.

In *Herne Bay Steam Boat Co v Hutton* 1903 2 BKB 683, a boat had been hired to tour the fleet and to watch the King's review of it, which was part of the coronation celebrations. The King's illness meant that the review was cancelled. In this case, however, the contract was not frustrated. The tour of the fleet was still possible and this was a significant element in the contract. The hirer remained obliged to pay for the use of the boat.

- Effects of war rendering contracting with the enemy impossible/illegal

In *Fibrosa SA v Fairbairn Lawson Combe Barbour* 1942 UKHL 4, it was held that, in time of war, a government may make trading with companies based in enemy territory illegal. Contracts with such companies which were made prior to this action will be frustrated.

In *Avery v Bowden* (1856) 5 E & B 714, a charter party was frustrated when the government declared war and prohibited shipping. It was no longer possible to perform the charter party.

The frustration need not result from direct government action.

In *Finelvet AG v Vinava Shipping Co Ltd* (1983) 1 WLR 1469, the continuing war between Iran and Iraq trapped certain ships in the Gulf for a lengthy period. Contracts relating to the charter of these ships were held to be frustrated.

- Other governmental actions rendering the performance of the contract illegal/contrary to law

  In *Gamerco SA v ICM/Fair Warning Agency* 1995 1 WLR 1226, a stadium which had been booked for a pop concert was closed for reasons of health and safety. It was held that the contract for the hire of the stadium was frustrated.

Categories of frustrating events are not exhaustive. It is possible to argue that some novel occurrence has frustrated a contract provided that it has the required effect on the rights and obligations of the parties to the contract.

Limitations on the doctrine of frustration

- The frustrating event has been foreseen or should have been foreseen and provided for in the contract.

  In *Severfield (UK) Ltd. v Duro Felguera UK Ltd*. EWHC 3066 it was stated obiter, that in modern times, court should avoid recourse to the doctrine of frustration whenever the parties have made contractual provision for the event that has occurred.

  Thus, in the commercial arena, Force Majeure and similar clauses may well replace the common law and statutory rules on frustration.

- The alleged frustrating incident has been self-induced by one of the parties to the contract. In the Roman Dutch Law, the same result would follow when the impossibility is caused by the negligence of the parties; Weeramantry, Law of Contracts, 757.

- The supervening event must have made the contract impossible, illegal or radically different. It is not sufficient that the performance of the contract has simply become more difficult, inconvenient or expensive, for in such a case, the basic assumption underlying the contract is not destroyed. Furthermore, mere difficulty of performance is a risk undertaken by the parties to any contract.

- Part of the contract can still be performed i.e. some of the purposes of the contract can still be fulfilled.

- When the parties expressly provide for the frustrating event. However, even where express provision is made by a term to the contrary, a contract will be frustrated where the cause of frustration is supervening illegality. This is due to public policy.

  Parties sometimes provide against the eventuality of a frustrating event by a *Force Majeure* clause, suspending an obligation should such eventuality arise. In such an event, when the eventuality arises which might otherwise frustrate the contract, the *Force Majeure* clause applies, suspending an obligation, but the whole contract is not frustrated.

Consequences of Frustration of a Contract

Consequences of frustration of a contract include the contract being discharged, money payable or goods deliverable cease to be payable or deliverable and/or money already paid before the frustrating event can be recovered subject to the other party's right to deduct from that amount a sum for the expenditure incurred in performing the contract unto the point of frustration.

Force Majeure - Where the Definition of Force Majeure is Constantly Changing

What is a Force Majeure clause?

A Force Majeure clause is a provision which, when incorporated into a contract, entitles a party to terminate or temporarily suspend all or part of the contract upon the occurrence of some triggering "Force Majeure" event. A Force Majeure clause will generally specify a list of triggering events and a catch all item such as "any other act of God".

A Force Majeure clause may be drafted narrowly, limited to a specified list of Force Majeure events or widely, open to interpretation. If drafted widely, a party may invoke the Force Majeure clause if an event beyond their control renders the contract impossible or impracticable. However, generally, Force Majeure clauses are construed narrowly by courts.

In *Mohamed and Sons v Zahiere Lye and Co* 46 NLR 101 it was held that any direct legislative or administrative interference would come within the meaning of the phrase "*Force Majeure*".

Can the Covid-19 pandemic trigger a Force Majeure clause?

Where a contract contains a Force Majeure clause, a party can seek to rely on it by premising that the Covid-19 pandemic is a Force Majeure event in the following situations:

- Where a pandemic/disease is specified as a Force Majeure event.

- Where certain consequences of the COVID-19 pandemic such as trade embargoes, lockdowns, curfew, national emergency, and closure of borders including Airports and Harbours, constitute a Force Majeure event.

By including a Force Majeure clause, parties can decide what remedies are available to them in the event such clause is triggered. Parties can also decide to what extend the obligations under the contract will be discharged/suspended.

An advantage of relying on a Force Majeure clause instead of pleading supervening impossibility of frustration is that unlike the latter, a Force Majeure clause does not discharge the entire contract. In fact, a Force Majeure clause may only suspend the whole or part of the contract until the triggering event has passed or the suspension may only be limited to certain obligations.

Therefore, a Force Majeure clause may serve businesses better in that it helps preserve long term business relationships. In a commercially driven world, it is imperative that business act today while keeping an eye on tomorrow. In other words, although performance may be impossible at present, the continuity of the business post-crisis must be borne in mind.

Whilst it is for this reason, Force Majeure clauses are incorporated into many commercial agreements, the language of the clause must be considered carefully.

A most common problem that parties' are faced with in the Covid-19 related business environment is that the Force Majeure clause in their contracts do not include a "pandemic", "epidemic" or "outbreak of disease" as a triggering event. However, where the clause includes a catch-all phrase such as "act of God" or "an unforeseen event or circumstance", it can definitely be premised that the pandemic or the effects thereof would fall within the ambit of the Force Majeure clause.

Governments in numerous countries have ordered lockdowns and closed offices and factories to curb the Covid-19 outbreak. As such, a clause including "government actions prohibiting or restricting a party from performing its obligations under the contract" as a triggering event could also allow a party to invoke the Force Majeure clause.

Even if the contract includes a Force Majeure clause which clearly contemplates a situation such as Covid-19 as a triggering majeure event, several factors need to be considered before such a clause can be invoked; For example, it must be considered whether the contract imposes an obligation upon the party seeking to invoke the Force Majeure clause to give timely notice of the inability to perform to the other party.

Furthermore, there may be instances where the contract imposes a duty on the parties to mitigate the effects of the Force Majeure event. The wording of the clause may impose an obligation to consider of alternative options before the clause is invoked such as finding alternative suppliers, looking beyond a certain region/area etc.

Another common issue that may arise is where a party chooses to honour certain contracts while seeking to discharge their liability under other contracts, where all contracts are affected by the same Force Majeure event.

It is vital that parties look to safeguarding their interests by drafting carefully worded Force Majeure clauses to be included in future contracts.

Viable Alternatives – Renegotiation and Extension

While supervening impossibility and frustration will effectively discharge the entire contract, a Force Majeure may only terminate or suspend the whole or part of a contract.

In the current adverse economic conditions, both governments and businesses have stressed the need for business (and relationship) continuity, where possible. Thus, from a commercial perspective, given that the effects of any crisis such as COVID-19, are also global, businesses may find renegotiation of contractual terms or extensions a more viable option than seeking remedies under supervening impossibility, frustration and/or Force Majeure.

Through renegotiation of contractual terms so that they are favourable to all parties in the present context, parties can prioritise maintaining long-term business relations.

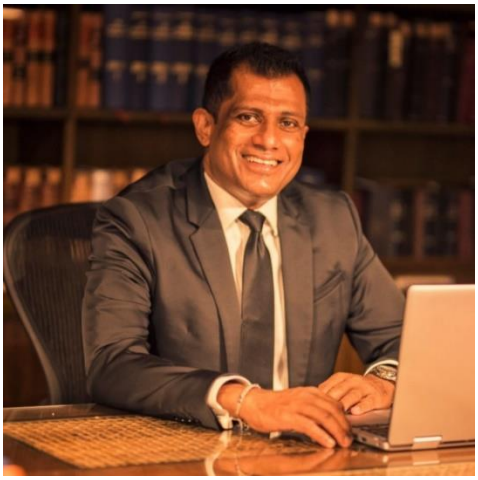
Conclusion

Maintaining business integrity in the face of adversity is by no means an easy task. However, maintaining a positive business attitude and making prudent decisions by thinking not only of the present but also of the future is a vital part of economic recovery and growth.

In light of the above discussion, it is apparent that a global crisis affects both parties to a contract. When relying on impossibility of performance, frustration or most commonly Force Majeure clauses, parties must be careful so as not to misuse or abuse their power to avoid obligations.

It is imperative that a balance be struck between securing a party's interests and honouring obligations whenever possible.

5th August 2020.



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