

BUSINESS INSIGHTS

COVID-19: Force majeure and frustration of your contracts

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As the spread of the coronavirus disrupts business, contracting parties are starting to consider whether force majeure or frustration have altered or discharged contractual obligations to perform.

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Key takeouts

Parties to contracts should consider whether their contract includes a majeure clause. Force majeure clauses differ between contracts and a clause may not be drafted in a way which makes it operative in the current circumstances.

Parties to contracts may consider looking at the doctrine of frustration to discharge their obligations under a contract. However, frustration will only occur if the circumstances in which performance of the obligation is required are rendered radically different from those originally contemplated by the parties under the contract.

The spread of COVID-19 does not mean that a force majeure clause will be operative or that a contract will be frustrated. Parties will need to consider the specific impacts COVID-19 is having on the performance of obligations in the context of their contract.

The World Health Organization recently declared coronavirus (COVID-19) a pandemic and the situation is rapidly evolving. Implementation of social distancing measures has seen a number of major events cancelled in Australia, including the Australian Grand Prix, Vivid Sydney, the Sydney Film Festival and various public ANZAC Day commemorations. It is clear that the virus is disrupting all major industries, especially sectors of the economy dependent on global supply chains. Over the next year, supply agreements and event contracts in particular will come under the spotlight as Contracting parties seek relief for obligations which were not performed due to the impacts of COVID-19. Parties will be starting to consider whether their contractual obligations can be discharged as a result of COVID-19 by means of a force majeure clause or the doctrine of frustration.

Force Majeure

What is a force majeure clause?

A force majeure clause relieves a party from performing its contractual obligations due to an event outside the reasonable control of the affected party. In Australia, force majeure is not generally recognised in common law, rather it is a contractual concept. As force majeure is a product of contractual negotiations, parties have the freedom to negotiate force majeure clauses as they see fit, meaning that force majeure clauses will vary from contract to contract. Common force majeure events include 'acts of God', 'natural disasters', 'government action or interference', 'labour shortages', 'national emergencies' and 'acts of war'.

Does a force majeure clause apply to COVID-19?

To determine whether a force majeure clause applies to circumstances arising from COVID-19, parties should examine whether the definition of a force majeure event includes terminology such as 'infectious disease', 'epidemic', 'pandemic' or similar. It is also possible that COVID-19 could lead to the occurrence of other events usually included in a force majeure definition such as 'government action', 'national emergency' or 'labour shortages'.

Parties should also consider whether the force majeure clause will be activated in the event any obligation becomes affected by a force majeure event, or whether it only applies to certain obligations. Additionally, parties should understand how the force majeure clause applies to their obligations and whether the clause applies equally to each party to the contract.

It should also be noted that force majeure clauses often require notice to be given by a party affected by the force majeure event to the other party, and the trigger for when this notice is required may be unclear, especially in the current circumstances.

For example, an obligation may have been able to be performed at the time COVID-19 was declared a pandemic, but may now be impossible due to government restrictions on public gatherings. In this instance, was the triggering event when the World Health Organisation declared a COVID-19 a pandemic, or was when the Australian government announced restrictions on public gatherings? The trigger point will depend on the contract and which obligations have been affected. Sometimes it is helpful to 'agree' with a counterparty (if possible) which specific date or event should require notification to trigger the force majeure clause. This is especially important where the party seeking to rely on the force majeure clause bears the burden of proof.

Parties will further need to consider if the outbreak of COVID-19 is genuinely a force majeure event in the context of the contract, ie whether the pandemic has caused real restrictions that prevent the affected party from performing its contractual obligations, or whether a party has merely been inconvenienced or suffered financial loss. This will depend on how the force majeure clause is drafted and how the clause can be interpreted.

Some clauses refer to acts 'preventing' a party from performing an obligation and this wording will likely be interpreted to mean that an obligation must become impossible to perform, rather than more difficult or costly. Other clauses may refer to "hinder", "impede", "impair", or "delay". Nevertheless, courts will usually require that performance be significantly more onerous, not just more expensive or burdensome to perform or less commercially desirable. If a party's primary obligation is to pay money, it would be unusual for a force majeure provision to waive that obligation while the other party is ready to fulfil their respective obligations.

Should a force majeure clause be activated?

Parties should think about the effect of the force majeure clause as this will differ between contracts. Common consequences of activating a force majeure clause include suspension of contractual obligations, excuse from liability for non-performance or delay, termination of contract, extensions of time, renegotiation of certain terms or certain contract remediation or governance measures. Any relief is often also only available for the duration of the force majeure event. Parties will also need to be mindful of any wrongful termination provisions in the contract, in the event a party's right to terminate under force majeure is disputed.

How will force majeure clauses be drafted in the future?

Parties should ensure that future agreements have a force majeure clause (including a definition of a force majeure event) that is well-rounded and seeks to cover the current COVID-19 pandemic and future events of a similar nature. Other points parties should consider when drafting force majeure clauses include whether the clause:

- addresses all obligations parties wish to be covered;
- includes the right to suspend or terminate the contract without penalty if the force majeure event continues for a sustained period;
- provides for payment to be suspended until obligations under the contract can be performed;
- provides for reasonable notification periods in the event an obligation is affected by a force majeure event; and
- requires the affected party to use reasonable efforts to minimise the effect of the force majeure event on the performance of their obligations under the contract.

Frustration

If a contract does not include an operative force majeure clause, then a party may look to the doctrine of frustration to see if the contract has been terminated for frustration.

What is frustration?

Frustration is a common law concept and occurs when circumstances have arisen, by no fault of either party, which result in the obligations under the contract becoming 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*" (*Davis Contractors Ltd v Fareham Urban District Council* [1956] AC 696 at 729).

When will frustration occur?

Whether the doctrine of frustration will apply to a situation depends on the contract between the parties and the effect the proposed frustrating event has on the ability of the parties to perform their obligations.

Examples of when frustration will generally **not occur** include:

- if there is an existing force majeure clause in the contract which operates to cover the circumstances seeking to be deemed a frustrating event;
- a delay in an obligation being able to be performed, unless such a delay is for an unreasonable time; or
- if the parties have merely suffered hardship, unforeseen loss, or the burden of performance has increased.

Frustration will be clearly established in an instance where it is impossible to perform an obligation, for example, if the supply matter has been destroyed or performance becomes unlawful. Additionally, if the contract requires personal performance of an obligation, the death or incapacity of a party may result in the contract being frustrated.

There is no hard and fast rule as to what event will be deemed a frustrating event by the courts. Rather, a party needs to consider whether the situation in which performance of the contract was originally contemplated has been rendered radically different. The standard of proof is very high, and typically higher than circumstances contemplated by a force majeure clause. Frustration will apply in respect of fundamental obligations in a contract, rather than peripheral ones.

What is the effect of frustration on a contract?

A contract which is taken to be frustrated will be terminated and outstanding obligations will be discharged. Liability for obligations performed before frustration remain. Parties should carefully consider the effect of claiming that a contract has been frustrated since, if a party takes the view that a frustrating event has occurred which is later determined to be incorrect, the mistaken party may have repudiated the contract.

Parties should also consider the impact of asserting that a contract has been frustrated, particularly if the contract is a long term contract on terms advantageous to the party asserting the frustration, or if the other contracting party is a particularly important commercial partner. Remember: frustration terminates a contract. It does not suspend it.

Under the common law, when a contract has been frustrated, losses lie where they fall. Consequently, any expenses incurred or costs paid in the preparation and performance of an obligation to recover to frustration cannot be recovered. A party may make a claim in restitution to recover the reasonable value of partial performance if it would be unjust to allow the receiving party to retain the benefit of that performance. In New South Wales (*Frustrated Contracts Act 1978* (NSW)), South Australia (*Frustrated Contracts Act 1988* (SA)) and Victoria (*Australian Consumer Law and Fair Trading Act 2012* (Vic)), legislation operates to reduce this harshness and provides for how rights may be adjusted if a contract becomes frustrated.

COVID-19 scenarios – will a contract be frustrated?

The below table sets out hypothetical COVID-19 related scenarios which highlight when frustration may and may not occur. Please note these are hypothetical situations only with basic analysis.

Example 1

A construction company operating in country A obtains its building materials from a factory in country B. Due to a substantial number of the employees at the factory having to self-isolate, the supply of building materials is delayed for two weeks.

Is contract frustrated? No – a two week delay is unlikely to be considered an unreasonably long period of time. Additionally, the construction company may be able to obtain the supply from elsewhere, and the fact that this may make the performance of the obligation more burdensome or expensive does not mean the contract is frustrated.

Example 2

A retail store is suffering a loss of revenue due to decreased foot traffic because people wish to save money and stay at home to avoid infection. The store owner leases the store space and pays rent monthly.

Is contract frustrated? No - the fact that the store has suffered financial loss due to people's reactions to the current situation is not sufficient to frustrate the contract.

Example 3

An audio-visual company has contracted with a concert organiser to provide the sound and lighting. However, due to a government ban on large indoor public gatherings, the concert can no longer take place.

Is contract frustrated? Yes – government action has meant that it is now impossible for the concert to take place and therefore for either party to perform its obligations.

What you should do now

Whether you are a supplier or customer, review your existing supply contracts, consider the effect of any force majeure clauses and whether these clauses can and should be activated in the current circumstances.

You may find that your contract could be considered to be frustrated. If that is the case, you should determine what approach you wish to take.

Pay special attention if you are in the process of drafting and negotiating force majeure clauses in a future contract as these can expose you to enormous risk.

Please contact us if you wish to discuss the impacts on your business.

Contact

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