Force Majeure vs Frustration and its implication in commercial contracts considering COVID-19 and beyond

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Abstract

The outbreak of deadly virus COVID-19 originating from China in a small town of Wuhan engulfed the countries across the globe. Despite government's profound steps the global markets and businesses are facing its wrath post its outbreak. This has lead slew of confrontations and concerns amongst Indian Inc. across all the boards.

An important question for Indian Inc, lawyers and scholars which needs determination upfront is their obligations to counter parties as to performance of respective contracts. The focus in this article is to review on judicial interpretation on doctrine of frustration and construing current status quo as to the suspension of commitments, delays in transactions and other rights and obligations in financing and other commercial contracts. [1] It is imperative to look at the current epidemic situation through a legal prism and its legal implications on commercial private contracts.

I. Introduction : Construction of Force Majeure clause in commercial contracts

The traditional approach accepted in both civil law and common law countries to contracts has been the binding character of the contract, 'pacta sunt servanda'. A commercial contract would be nothing but allocation of foreseen and unknown risks amongst the parties. Thus if the risk is known at the time of contract parties would provide for such risk ex-ante in the contracts. If it is otherwise, it means parties have impliedly under the contract taken those risks. However, problem arises in contracts wherein, post signing of contract unforeseeable situations or events arises during the life of such contract.

[1] Non-Performance of contract due to force majeure events, acts of god, earthquake, volcano, etc. Intention herein is to look beyond conventional obligations such as the outbreak of unprecedented pandemics like COVID-19

For the purpose of simplicity herein contract is divided into two parts; the performance part and non-performance section. The performance section constitutes major part of the contract wherein rights and obligations amongst the parties including representations and warranties along with terms of performance are determined in detail upfront. Whereas the non-performance section is generally carved out in a contract as; *exception* clauses (such as non-fulfilment of condition precedent or long stop date) or *Material Adverse Change (MAC)* or through ubiquitous *force majeure* clause.[2] Though these above mentioned exceptional clauses are mostly used in PE/VC funding contracts, however similar exceptional clauses with transaction specific commercial terms are used in other commercial contracts such as sales of goods and etc. The very nature and purpose of these clauses is to excuse from the performance of the contract due to happening of such exceptional event. The idea is that the non-performer is excused from performance and counterparty shall not claim any damages or specific performance of the contract. The primary focus herein is on force majeure clauses and their express and implied interpretation by courts. Part II of this paper focuses on judicial pronouncements and interpretation of force majeure clause by courts in India. Part III emphasises on construction of force majeure clause under UNDROIT principles while drawing parallels between the Indian jurisprudence on force majeure. The remaining part concludes with general application of force majeure and frustration doctrine in commercial contracts.

II. Indian Jurisprudence on Force Majeure and Doctrine of Frustration

Force majeure is not defined under Indian domestic legislations.[3] The early theory on 'doctrine of frustration' was adopted and applied by Hon'ble Supreme Court of India in Naihati Jute Mills case.[4] The judgement discussed common law theories propounded by English courts. The first theory discussed by court was of implied term,[5] "para 7…..*A court can and ought to examine the contract and the circumstances in which it was made, not of course to vary, but only to explain it, in order to see whether or not from the nature of it the parties must have made their bargain on the footing that a particular or a state of things would continue to exist. And if they must have done so, then a term to that effect would be implied; though it be not expressed in the contract."* This theory was rejected out rightly on the basis of argument that if

[2] These standard clauses are taken for understanding the context and structure of contracts.
[3] For the purpose's inclusion of force majeure in domestic legislation is not endorsed. It is argued that force majeure is privately negotiated clause and would materially differ from case to case basis; therefore it is best to be left parties to the contract.
[4] The Naihati Jute Mills Ltd.Vs. Khyaliram Jagannath AIR 1968 SC 522, [1968]1SC R821
[5] F.A. Tamplin Steamship Co. Ltd. v. Anglo-Mexican Petroleum Products Co. Ltd. [1916] 2 A.C. 397

parties to contract could foresee risks, they would have provided for it in contract or else, they are willing to assume that implied risk.[6] The courts purpose is not to establish or absolve equal footing ex-post in contracts amongst competent parties.

Another theory based on 'just and reasonable in the new situation' in contracts was given by Denning L.J, "*Even if the contract is absolute in its term, nevertheless, if it is not absolute in intent, it will not be held absolute in effect. The day is done when we can excuse an unforeseen injustice by saying to the sufferer. It is your own folly. You ought not to have passed that form of words. You ought to have put in a clause to protect yourself."*[7] This theory might hold firm grounds based on public policy conferring to equity and justice. This theory is very similar to above stated theory of implied term, and hence has its own shortcomings. Such a theory would mean inherent power of courts to go beyond express words of the privately agreed contract among the parties.[8]

The widely accepted doctrine of frustration theory was given by Lord Radcliffe in, *Davis Contractors v. Fareham U.D.C.* [1956] A.C. 166 formulated it in following words:- "*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 is important to note here that the thrust of the doctrine is on *'radically different'* which is discussed subsequently herein.[9]

In India closest governing section to this regime of private law could be found under section 32 and 56 of the Indian Contract Act, 1872 (hereinafter 'the Act'). Section 31 of the Act defines 'contingent contract'- *"...is a contract to do or not to do something, if some, event, collateral to such contract, does or does not happen"*. Section 32 of the Act deals with enforcement of contingent contract which stipulates, a contingent contract cannot be enforced by law, until such uncertain future event has happened. While bare reading of section 56 of Indian Contract Act governs impossible agreements. That is an agreement to do an act impossible in itself is void.

[6] Russkoe v. John Strik & Sons Ltd. I.L.R. [1922] 10 214; in 'Anson's Law of Contract', 22nd ed. p. 466
[7] Movietones Ltd. v. London and District Cinemas Ltd. [1951] 1 K.B. 190
[8] Such a stance was also refuted by Supreme Court in Satyabrata Ghose v. Mungneeram Bangur, AIR 1954 SC 44.
[9] See n(20) Infra

In Naihati Jute Mills Ltd (Supra), wherein the Appellant contented that due to subsequent imposition of ban on import license for importing Jute from Pakistan has frustrated the contract and hence void. The Supreme Court refrained from applying English doctrine of frustration to the said facts of the case. Such a restriction is also enshrined as a precedent by Supreme Court wherein it is not permissible by courts to travel outside the provisions of statutory section and import the principles of English law de hors.[10] The court iterated its own judgement, Ganga Saran v. Ram Charan,[11]which laid principle to invoke section 32 and 56 of the Act when any party claims a contract to be frustrated. The court further went on to explain that promise may be expressed or implied. On happening of the event as a matter of construction of terms of contract the obligation would stand discharged on happening of such event. The contract would dissolve under its own terms, and such cases would be outside the purview of section 56. That is there should be an express term in contract such as a force majeure clause stipulated in contract to trigger section 32 of the Act.[12] For the contracts which do not have any of such exceptional clauses or force majeure clauses the excuse from non-performance of such contracts could be sought under section 56 of the Act on grounds of impossibility. Where subsequent relief of impossibility is granted there is no need to investigate implied terms of the contract since parties could not have think of such circumstance or situation at time of the contract.[13]

It would not be wrong in saying that the Supreme Court in its judgement has narrowed down the scope of doctrine of frustration of contact. The court dismissed the defence on the grounds that neither the contract contained any express nor implied term to dismiss the contract on non-approval of import license, additionally there was an intention contrary to it. Further neither the contract was impossible to perform since the ban was to boost Indian jute market, the possibility of which appellant was well aware of during entering into contract and could have sourced its supply from Indian market.[14]

Thus, the court made it evidently clear a non-performance of the contract is only excused under two circumstances. Firstly, under section 32 of the Act wherein parties expressly or impliedly on happening of such an event excuses themselves in the terms of contract itself. Secondly where the contract becomes impossible or unlawful to perform under section 56 of the Act,

[10] Satyabrata Ghose v. Mugneeram Bangur *&* *Co*, AIR 1954 SC 44
[11] [1952] S.C.R. 36; See para 12-13
[12] This brings back the debate on powers of court 'de hors' the contract. See n (16) - infra
[13] Naihati Jute Mills Ltd. Vs. Khyaliram Jagannath, n(8), para 14
[14] Id. paras 16-18

here court need not look express or implied terms under the contract i.e. courts can look beyond intention of parties and terms, 'de hors' the contract. For cases where any event make a contract impossible or illegal to perform would be automatically covered under section 56 of the Act. Therefore, it becomes more imperative for the parties to contract to construe non-performance section of contract covering foreseeable and unforeseeable risks to terminate the contract under section 32. The contracts should provide for unforeseen event which is beyond the control of parties in such a manner which keeps both the parties on equal footing and do not render injustice on either part. Also where parties could see forthcoming risks but are beyond their control obligations should be determined in 'exception clause'. For example; government approvals, licenses, change in law and etc.

For the purpose of unforeseen events beyond the control of parties such as fire, earthquake, floods or even an outbreak of pandemic such as corona virus (COVID-19) the list is exhaustive by the very nature of these events.

The courts in India have taken different legal approach by invoking section 32 and 56 of the Act to doctrine of frustration and force majeure. Yet Indian jurisprudence has been following line of common law English courts, fundamentally the rationale and guiding principles have been similar. An interesting approach could be taken from the case of Energy Watch dog.[15] Though the issue in hand in the case was not to rescind the contract but the one wherein appellant demanded compensatory price (renegotiation) of a PPA (Power Purchase Agreement) from central commission on grounds of material change in price of imported coal from Indonesia. The PPA contained an elaborative force majeure clause; the construction of the clause was taken in light of section 32 of the Act. For the purpose of argument herein, if a clause is construed to the one under section 32 than section 56 of the Act does not apply.[16]

The material part of force majeure clause under PPA "41…*Force Majeure' means any event or circumstance or combination of events and circumstances including those stated below that wholly or partly prevents or unavoidably delays an Affected Party in the performance of its obligations under this Agreement, but only if and to the extent that such events or circumstances are not within the reasonable control, directly or indirectly, of the Affected Party and could not have been avoided if the Affected Party had taken reasonable care or complied with Prudent Utility..*"

[15] Energy Watchdog Vs. Central Electricity Regulatory Commission & Ors. (2017)14 SCC 80
[16] Id. para 45; also see Satyabrata Ghose v. Mugneeram Bangur & Co, AIR 1954 SC 44

The court did not consider the force majeure clause under PPA as one to be activated, despite accepting that the definition of force majeure clause is inclusive and not exclusive.[17] The court interpreted the word 'hindered' which occurred at many places in the clause that mere rise in price of imported coal cannot be hindrance or stop parties from performing their part of obligation. Further the court interpreted the rise in price of imported coal covered in the expressly stated non force majeure events in the PPA. The mere fact that performance of contract has become erroneous on one party does not change the material object of the contract.

The court as following its earlier precedents did not change its stance. However, an interesting insight was given by the court in its judgement by way of obiter dicta.[18] In which it cited Peter Dixon & Sons Ltd v. Henderson, Craig & Co. Ltd. 1919 (2) KB 778. In the said case British ships were not available at beginning of First World War, although there was an option to avail foreign ships, but it could have meant such ships liable to capture by enemy, destroyed through mines or sub-marines. The rationale adopted by the court from deviation from contract was that the sellers therein 'hindered' or 'prevented' from performing their obligation not merely on price. But they have shown much more than that, the whole trade was dislocated by the reason of difficulty.

The Supreme Court also cited Sea Angel case, 2013 (1) Lloyds LawReport 569[19] wherein the doctrine of frustration was put to test. A multifaceted approach was given to the doctrine, wherein 'radically different' test was laid.[20] The English court argued that multiple factors such as terms of contract, expectations, matrix or context, assumptions and contemplations as to risks at the time of contract. The nature of supervening event, parties reasonable and objective calculations as to possibilities of future performance under new circumstances. Contracts are allocation and assumption of risks, and it is not matter of implied or express provision but less easily defined the contemplation of parties. Thus, radically different test would have to provide for break in identity between contract as provided for and contemplated and its performance in new circumstances. Mere incidence of expense or delay or burdensome is insufficient to invoke frustration.

Thus party claiming non-performance under force majeure has to show that the supervening event has radically altered what parties initially consented for. That is either substance of the

[17] Id. para 42
[18] Id. para 43
[19] Id para 39
[20] See n(9); Refer to the main text on definition of frustration of contract.

contract (purpose) is defeated or has rendered it the one to which arties did not consented for. It is argued those force majeure clauses or other exception clauses such as MAC in private financing deals or in other commercial contracts would strictly depend on language of the clauses. That is inclusiveness or exclusiveness of language and other contemplations and objective of parties at time of entering into contract such as time is of essence clause or objective to procure any goods and many other contracts where primary objective is to earn profit would be crucial and at the helm of judicial interpretation.

III. UNDROIT Principles and construction of Force Majeure clause

It has been argued that the excuse for non-performance are usually carved out as *force majeure* clause in commercial contracts wherein parties mutually agree to situations were rights and obligations created under the contract would be non-binding. That is a force majeure event would discharge the defaulting party from its obligations to perform. However, intuitively owing to its private character *force majeure* do not find place in UN Convention on Contracts for the International Sales of Goods (CSIG) nor it is specifically defined in domestic legislations of the countries. The wide use and practice of this doctrine in commercial contracts internationally necessitates assigning legal definition to it. The closest reference to force majeure for the purpose of incorporation of force majeure clause in commercial contracts and its interpretation is found in UNDROIT Principles of International Commercial Contracts 2016 'herein after, the principles'. Article 7 of the principles enshrined under Chapter 7 defines Non-Performance in general as failure by a party to perform any of its obligations under contract including defective or late performance.[21] The principles in its Article 7.1.7 (force majeure) stipulates "*Non-performance by a party is excused if that party proves that the non-performance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.*"[22]

The Articles further requires where impediment is temporary the excuse for non-performance shall have effect for such reasonable period and the party failing to perform must give a notice to other party of impediment and effect on ability to perform. Such an inclusive definition of force majeure could be incorporated in contracts along with procedure of notices to the counterparty on happening of such event. In case of non-receipt of such notice the failing party

[21] UNDROIT Principles of International Commercial Contracts 2016, Article 7.1.1
[22] Id. Article 7.1.1 para 1.

should be liable for damages, moreover while nothing shall prevent the right of the party to terminate, withhold, or request interest on money due.[23] The word right of the party would mean any of the party have right to terminate the contract, withhold or request interest on money due. In the comments to the Article it is purported that the definition is grounded on the doctrine of frustration and impossibility of performance under common law and doctrine of force majeure developed by civil law countries.

It is important to mark a caveat in the term 'impediment' shall not be confused with 'hardship', which finds a separate place under the principles, Article 6.2.2 *"There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and (a) the events occur or become known to the disadvantaged party after the conclusion of the contract; (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; (c) the events are beyond the control of the disadvantaged party; and (d) the risk of the events was not assumed by the disadvantaged party".*

The hardship clause is very subjective, parties could incorporate standard clause or elaborate specific clause as to what would amount to hardship. There is hardship when fundamental alteration in equilibrium of contract. That is increase in cost of performance for one party or decrease in value of performance received by other. There could be factual cases which give rise to both hardship and force majeure. However guiding principle in such cases could be where hardship is invoked as first instance would call for re-negotiation while on other hand if force majeure is invoked the primary motive being excuse from non-performance.[24] The parties may negotiate the terms of contract in hardship either themselves or on direction by court as to performance. However, courts could terminate the the agreement as under force majeure clause or distribute the losses amongst parties (restoring equilibrium).[25]

Though these principles are non-binding and soft law in nature, however they play a guiding framework for legislators and judges to have judicial uniformity and follow internationally accepted best practices by member nations.[26] India is a signatory to the principles therefore an

[23] Id. Article 7.1.1 paras 2-4;
[24] Id. ARTICLE 6.2.1
[25] Id. Article 6.2.3 para 7
[26] For argument on uniformity of law in cross border transactions See, Roy Goode, Herbert Kronke et.al., 'Transnational Commercial Law', 2007 OUP

attempt is made to draw parallels with international best practices. In *Naihati Jute Mills Ltd* and energy watch dog cases the court interpreted the facts and circumstances of the case as one of hardship and therefore did not excuse the non-performance in either of the cases. In the former case the court ensured the performance while in the latter case the case was directed for re-negotiation.

IV. COVID 19 and non performance in Commercial Contracts

The frustration is invoked on equity principles, wherein the party claiming excuse from performance must not have any role or cause such frustration to contract.[27] That is cause of frustration must be exogenous (beyond the control of parties). This is of importance because there might be situations or circumstances endogenous (by parties own default or under control). For the purposes of private funding transactions, where the pandemic has lead triggering of exception clause such as non-fulfilment of condition precedent or failure to close within specific time period. The party claiming such defence has more chances to excuse or walk away from deal or transaction. The lock downs and closure of business operations have altered the economic situation drastically with drain on supply-demand and value of businesses. Such risks are hedged through general MAC clauses; drop in value of assets, decrease in revenue, closure of operations and etc. A recent fall of Sycamore partners over L Brands Victoria secrets deal over triggering of MAC cause is at the centre of contest. Though the MAC clause in transaction document stipulated that pandemic would not be cause MAC to trigger. But the deal fell apart and parties went for settlement without litigation.[28]

There is a strong argument for not interpreting MAC clause as one of frustration. Firstly the frustration doctrine calls for unforeseeable event whereas the MAC clauses does not provide for such condition. Secondly the secondary purpose of contract (to earn future revenue and profit) is defeated while the primary purpose to acquire the target might still persist.[29] Therefore the standard rule being exogenous risk should be on the acquirer while the endogenous risks on the target. Thus it does not make commercial sense to equate MAC with frustration doctrine or force majeure clause.

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[27] Equity does not relive person through his or her own fault. See, Mark P. Gergen, *A Defense of Judicial Reconsnuction of Contracts*, 71 IND. LJ. 45, 71

[28] Lisa Fickenscher, *Drawer slams shut on Victoria's Secret acquisition*, NY Post, May 4, 2020.< https://nypost.com/2020/05/04/deal-to-buy-victorias-secret-falls-through/> Last accessed May 22, 2020

[29] Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330 (2005)

The force majeure situation (outbreak of COVID -19) has also given rise to other exogenous risks such as global capital meltdown and various systemic risks. If radically different approach is invoked for determining frustration of contracts while the targets bearing all the burden of exogenous risks. It is argued that courts would hardly take such a approach since contemplation of parties are not materially altered rather could such a situation be addressed as a hardship. Where equilibrium of contract has changed in such a manner that value of performance received by one party decreases (not destroyed completely) and such force majeure or MAC could be used as a bargaining chip to restore equilibrium.

In contrast commercial agreements related to supply chain such as energy, infrastructure and others. It would be material on the non-performing party to show to courts that outbreak of COVID-19 has materially altered the situation governing the contract. The onus is on party claiming such defence to show that the pandemic has either frustrated the contract (as under section 32 of the Act) or its performance has become impossible (as under Section 56 of the Act). The substance of the contract would flow from the obligation created under the contract. That is real obligation or personal obligation.[30] For example in *Naihati Jute Mills Ltd.* had the contract provided for jute to imported has to be only from Pakistan or similarly Energy Watch dog case coal has to be imported from Indonesia specifically. A subsequent ban on import or interruption in supply chain from those countries would have discharged party from performing its obligation as it would be rendered the performance impossible.

V. Conclusion

The courts in India have very rarely or sparingly invoked doctrine of frustration. The mere fact the performance of the contract has become onerous, or material loss, incidence of expense or delay caused by one party is not sufficed to invoke this doctrine. It has to be shown much more than that, such as dislocation of whole trade, loss of stratum or subject matter of contract. The newly adopted approach to doctrine of frustration by English courts by proposing 'radically different' approach. The contemplations as to risks allocation at the time of contract is well

[30] The argument takes it rationale from the discussion on real right (right in corporeal or tangible property) and personal right. See Ewan McKendrick, Roy Goode, Goode on Commercial Law, Lexis NexisButterworths (5.ed 2017), See part 1 s

founded but does not provide for obligations in financing transactions. Though the obligation and remedies available on parties on occurring of such *MAC or FM* event would be subject specific, on the basis of implied and express terms to the contracts amongst the parties, i.e. to terminate the contract/ re-negotiate the terms/ deferment of the performance and etc.