COVID-19 and contractual obligations (New Zealand)

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COVID-19's effects are having a significant impact on the global economy and are likely to cause considerable disruption to commercial activities. As a result, many New Zealand companies are bracing for major changes to what was only a few weeks ago considered "business as usual".

So what recourse do you have if your commercial contracts are affected? Is there a way to terminate or "get out" of your contracts? What clauses should you be looking at?

We set out below some key considerations for companies and individuals to assist with navigating this tricky area.

Force Majeure:

Your first consideration should be whether the contract includes a *force majeure* clause. A *force majeure* clause (French for "superior force") is a provision that allows a party to suspend, terminate or extend the time for performance of its obligations when certain circumstances beyond their control arise, making performance inadvisable, commercially impracticable, illegal, or impossible.

Force majeure can only be relied upon if such a clause is included in the contract and the parties have specifically agreed to the term. There is no separate rule or law implying *force majeure*. As such, the specific wording of the clause at issue is crucial in working out if it applies. However, we set out below some general observations on such provisions.

The provision will often be worded to include a list of events which result in the parties being unable to perform the contract (for example, war, riots, fire, flood, hurricane, earthquake, lightning, explosion, strikes, lockouts etc). Key wording to keep an eye out for in relation to the spread of COVID-19 would be "epidemics or pandemics", and acts of state or governmental action prohibiting or impeding a party from performing its obligations. More generic references to causes beyond a party's control or to an "Act of God" might also assist.

The level of impact on performance is another key consideration in determining whether a party may enforce or rely upon the *force majeure* clause. *Force majeure* must generally 'prevent', and not just hinder or make uneconomic, contractual performance. The courts tend to hold that it is not enough that performance is more difficult or expensive, instead it must be legally or physically impossible. However, drafting can at times implement lower thresholds, such as an event having 'hindered', 'delayed' or 'adversely affected' a party's performance.

Whether there is anything that the party relying on the clause could 'reasonably have done' to avoid or mitigate the impact of the event will also be considered when a party is looking to terminate or suspend a contract on the basis of a *force majeure* event. 'Reasonable efforts' may include incurring financial losses, though the extent or quantum of loss that a party may be required to incur may be finite and dependent on the circumstances.

The standard for application of a *force majeure* clause is reasonably high. Based on the traditional narrow scope of

force majeure, and the presumption that contracting parties do not generally intend to exempt performance unless clearly provided for:

a. *force majeure* language will tend to be construed narrowly;
b. ambiguity will likely be resolved against the claiming party; and
c. the burden to demonstrate *force majeure* and compliance with obligations of mitigation will be on the party claiming *force majeure*.

Therefore, a detailed review of the contract and research of supporting or applicable case law should be carried out before any steps are taken. If a party was to terminate a contract in reliance on a *force majeure* event and the court held this reliance to be unfounded, that party may be liable for damages for wrongfully repudiating the contract.

Frustration:

If the contract does not include a *force majeure* clause, contracting parties may be able to argue that the impact of COVID-19 has "frustrated" the contract.

The common law doctrine of frustration allows a contract to be discharged on the occurrence of certain events beyond the control of the parties which would make the performance of the contract impossible or the obligations under the contract being “radically different” from those contemplated by the parties to the contract.

Examples include a change in law or government directive making performance of the contract illegal or the commercial purpose of the contract no longer existing (e.g. physical destruction of the subject matter of the contract).

In New Zealand the doctrine of frustration is supported by the Contract and Commercial Law Act 2017. It addresses the effect of the discharge of obligations on the areas of the contract already fulfilled.

The courts treat frustration as a high threshold to be met. This is because the effect of frustration of a contract is absolute - the contract is terminated, and the parties are discharged from their obligations. Therefore, parties should tread with caution and on the basis of sound advice if asserting frustration.

Other considerations:

When assessing your position in relation to COVID-19 and your commercial contracts, you should also look out for:

a. General termination/suspension provisions – is either party able to terminate the contract ‘for convenience’ (upon providing a certain amount of notice), on a cessation of business, or a drop in purchase volumes over a particular level?

b. Material adverse change/effect clauses (‘MAC’) – these provisions allow a party to cancel the contract if triggered. They are different in a number of ways to *force majeure* clauses, particularly as they do not generally specify events that may give rise to the MAC, but rely on general descriptions of the types of impacts required for relief; for example, an event reasonably likely to have a material adverse effect on the financial condition, operations, revenue or prospects of the business. MAC clauses may specifically exclude the effects of things such as general market conditions, Acts of God and similar events. COVID-19 may be such an event depending on the particular circumstances. However, invoking such a clause is not simple. Materiality needs to be demonstrated clearly and objectively. Because what constitutes a ‘material’ event is often not specified, the courts generally hold this to a high level, such as a decision to not otherwise enter into the contract.

c. Change in law - depending on the approach taken by the Government from this point forward, this might become relevant. Consequences could include the right to suspend or terminate the contract, or to seek price or time relief. For instance, the recent decision to ban events of more than 500 people, could well trigger a change in law in

contracts for public events.

d. Financial covenants – these are most relevant to loan agreements. A decrease in revenue will likely influence the ratios and other thresholds required to be maintained by a borrower and a breach of such covenants will more than likely be an event of default under the loan.

If you would like assistance in reviewing your contracts to understand your position and available options, please get in touch with the contacts listed with this article or your usual Dentons Kensington Swan relationship manager.

One of the advantages of being part of a global law firm is that we have a ‘COVID-19 (Coronavirus) Hub’ for use by clients. It has a range of articles and other information from Dentons firms all over the world which will be of interest, especially should you have operations in other parts of the globe. You can find the Hub here.

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