DISPUTE RESOLUTION BRIEFING

Market shocks: the impact on the disputes landscape

Within the last few years, a series of unexpected and disruptive macro-events, from the COVID-19 pandemic to the Russian invasion of Ukraine, have shaped the economic climate and had a significant impact on the legal landscape.

These types of events can cause major challenges for supply chains, present business continuity risks, and pose difficulties for companies in planning for and dealing with disruption. They also throw light on legal risks and uncertainties, with contractual risk allocations put to the test and, inevitably, disputes arising as to where losses should fall.

Market shock events

A market shock is an event that is beyond the control of an organisation or its counterparties, and which disrupts ordinary operations. The COVID-19 pandemic is an obvious example, with the attendant disruption to travel, logistics and workplace environments (*see feature article "Navigating turbulence: opportunities among a deluge of disruption", www.practicallaw.com/w-026-9048*). So too is the Russian invasion of Ukraine which, beyond the immediate impact on Ukraine, has disrupted energy markets and supply chains, and triggered a wave of sanctions that is affecting organisations doing business involving Russia (*see News brief "Russian sanctions: responding to a complex situation", www.practicallaw.com/w-035-3181*).

Besides these large-scale, globally significant events, other more localised or short-term market shock events also present risks. In the UK, the September 2022 collapse in the value of sterling following the government's mini-budget and the Brexit vote in June 2016 both had a major impact on organisations that were exposed to particular risk profiles.

Managing future uncertainties

The traditional mechanism of providing for uncertain future events in English law contracts is through a force majeure clause (*see feature article "Force majeure in a changing world: predicting the unpredictable", www.practicallaw.com/w-019-2821 and box "Lessons from other jurisdictions"*).

Force majeure clauses operate by defining circumstances beyond the parties' control that may render performance of the contract substantially more onerous or impossible. Generally, where a force majeure event occurs, the clause will operate to suspend or release the affected obligations. Force majeure clauses are inherently seeking to provide for the unexpected, and need to be designed to respond to the wide variations and permutations in how the unexpected might occur.

Since force majeure has no specific meaning under English law, the interpretation of the clause is specific to the contract in question. Typically, the contract will list the types of event that might constitute force majeure, and then identify the consequences that the event must have in order for the clause to take effect.

A typical example is provided by *MUR Shipping BV v RTI Ltd*, where a dispute arose over cargoes of bauxite (*[2022] EWCA Civ 1406; www.practicallaw.com/w-037-7125*). The shipowner relied on a force majeure clause to excuse performance of a contract of affreightment after the charterer's guarantor and parent company were sanctioned by the US Office of Foreign Asset Control, so that US dollar payments were not permitted. The force majeure clause required that the event:

- Was outside the immediate control of the party giving the force majeure notice.
- Prevented or delayed the loading or unloading of the cargo.
- Was caused by one or more of a series of causes, including any rules or regulations of governments or any interference or acts or directions of governments.
- Could not be overcome by reasonable endeavours from the party affected.

Where a force majeure event occurred, performance was suspended with no liability for loss or damage.

Other force majeure clauses may include staged consequences where, for example, performance is suspended for an initial period but if the event continues then the contract comes to an end. Another variant is that the parties become obliged to discuss in good faith how to proceed.

In *MUR Shipping*, the Court of Appeal held that a proposal by the charterer to pay in euros would have resulted in the shipowner receiving exactly the same financial outcome as the contracted US dollar payment, so the force majeure event could reasonably be overcome by the shipowner agreeing to accept payment in euros.

When a potential force majeure event occurs, the terms of the clause come into sharp relief and will be closely scrutinised in any litigation. When drafting contracts, businesses are advised to consider the possible consequences at the outset, including:

- What events are covered and whether catch-all language is needed for disruptive events that are not specifically identified.
- Whether performance should be relieved if it becomes more onerous, or only if it becomes impossible.
- Whether the contract should provide for alternative non-contractual performance, such as payment in an alternative currency, or exclude that possibility.
- The consequences of the event occurring; for example, whether performance should be suspended and, if so, for how long.
- Whether there should be an obligation to renegotiate or a termination right.

Frustration

The second main mechanism for addressing unexpected adverse events is the doctrine of frustration (*see feature article "Terminating for breach of contract: look before you leap", www.practicallaw.com/w-016-9676*). This applies where an event occurs after the formation of the contract that renders it physically or commercially impossible to perform a fundamental obligation in the contract, or renders a fundamental obligation

© 2023 Thomson Reuters (Professional) UK Limited. This article first appeared in the March 2023 issue of PLC Magazine.

radically different to that which was originally envisaged when the contract was entered into. It is necessary that the frustrating event was not foreseen by the parties. Therefore, where a force majeure clause covers the event in question, frustration will not apply.

These are high thresholds and, in practice, are difficult to rely on. In *Canary Wharf (BP4) T1 Ltd v European Medicines Agency*, the European Medicines Agency (EMA) claimed that a 25-year lease of premises in London was frustrated following Brexit, which required the EMA to relocate (*[2019] EWHC 335 (Ch); see News brief "Commercial contracts: is Brexit frustrating?", www.practicallaw.com/w-019-6097*). The High Court found that it was foreseeable in 2011 when the lease was agreed that, during its term, the EMA might have to vacate the premises and that Brexit had not radically altered the EMA's performance under the contract.

Market shocks and litigation risks

Where a market shock affects a party's ability to perform under a contract, often there will be a loss of value in the transaction and that loss will need to be allocated between the parties. This may occur in a supply agreement, such as where supplies are disrupted and value is lost (*see feature article "Business challenges: back to the future", www.practicallaw.com/w-036-8119*).

One example of lost value occurred in the context of the COVID-19 pandemic when some commercial tenants challenged rent payments for periods when they could not make commercial use of their premises. In *Bank of New York Mellon (International) Ltd v Cine-UK Limited*, cinema operators argued that government restrictions meant that there was a failure of the basis of consideration, and that it was an implied term of their leases that they were not required to pay rent when they could not lawfully use their premises as cinemas (*[2022] EWCA Civ 1021; www.practicallaw.com/w-036-6524*). The Court of Appeal rejected these arguments and found that the leases contained a carefully worked-out contractual regime for the allocation of risk, which had allocated the risk to the tenants.

There can also be situations where a market shock generates a substantial profit for one party at the expense of another. This can occur in transactions where one party is exposed to the risk of price fluctuations that can be triggered by external market shocks.

Where an organisation is faced with litigation risk in a market shock context, the first step will often be to analyse closely the parties' rights under the contract.

In times of disruption, a party may be much more inclined to stand on its strict

Lessons from other jurisdictions

The English law approach, where force majeure is a matter of contract between the parties and frustration is narrowly confined, is not mirrored in some other jurisdictions.

France

In France, the concept of force majeure is defined as "an event beyond the control of the debtor, which could not have been reasonably foreseen at time of signing the contract and whose effects cannot be avoided by appropriate measures, that prevents the performance of its obligation by the debtor" (*Article 1218, Civil Code*) (Article 1218). Where a force majeure event occurs, Article 1218 provides that a temporary impediment will suspend performance and a permanent impediment will terminate the contract. Therefore, unlike the position in England, parties automatically have the right to rely on force majeure even where it is not provided for in their contract.

For contracts signed after 1 October 2016, parties have a right to renegotiate if there is an unforeseeable change in circumstances that renders performance excessively onerous (*Article 1195, Civil Code*). If agreement cannot be reached, either party may apply to the court to revise or terminate the contract.

Germany

In Germany, parties usually provide for a force majeure clause in a contract. If the contract does not define force majeure, the courts follow the definition provided by the Federal Court of Justice; that is: "an external event that has no operational or personal connection to the parties and cannot be averted even by exercising the utmost diligence that could reasonably be expected". Where a commercial contract does not include a force majeure clause, statutory provisions apply such as factual impossibility or frustration based on an excessive impediment to performance (*sections 275 and 313, Civil Code*). In the latter case, parties can seek a contract adjustment.

Italy

Italy does not have a statutory definition of force majeure, but a similar concept is implied in several provisions of the Civil Code dealing with a "supervening impossibility due to a reason not attributable to the debtor" (*Articles 1218, 1256, 1463 and 1464*). A temporary impossibility may suspend performance of the obligation, while permanent impossibility may extinguish the obligation with no liability on the part of the debtor (*Article 1256, Civil Code*).

Article 1467 of the Civil Code addresses obligations that are affected by a "supervening excessive onerousness" due to "extraordinary and unforeseeable events". In such cases, the affected party may demand termination of the contract, unless the other party offers to modify its conditions equitably.

Hardship clauses

In some jurisdictions, hardship clauses are common in commercial contracts. They operate to adjust contractual rights and obligations where the performance of the contract is impeded or disrupted. The prerequisite generally is that the change in the original circumstances is of a profound and unforeseeable nature, is outside the control of the contracting parties, and causes such an impairment of the contractual balance that the further performance of the contract constitutes an undue hardship for at least one party.

© 2023 Thomson Reuters (Professional) UK Limited. This article first appeared in the March 2023 issue of PLC Magazine.

contractual rights than in more normal times, particularly if the economics for that party have changed. A party may prefer to be free of its obligations and less inclined to waive or overlook issues that would otherwise be capable of resolution.

If a party intends to rely on a force majeure clause, it will be essential to carefully analyse the terms and assess whether the events in question fall within its scope, including precisely how performance has become more onerous or impossible. Likewise, if a party is considering claiming frustration, it will need to be specific about precisely how its obligations have become impossible or radically different. This analysis will require careful fact-finding and detailed consideration of the operational mechanics of the transaction.

In a crisis situation, decisions on how to proceed are often made under pressure with imperfect information, and where there is a real possibility of disputes with counterparties. It is more critical than ever to proceed with caution, and only after careful evaluation of the options.

Spotlight on risk

Market shocks present unique challenges for the organisations affected by them. As well as the operational and financial challenges that can arise, the litigation risks can be acute and contractual arrangements can be subject to challenge. Careful consideration of clauses that are designed to deal with the unexpected is essential, as is a cautious and thoughtful analysis of the risks and options before making decisions about how to proceed under an affected contract. Ultimately, these risks cannot be fully mitigated and organisations should approach their decision making in times of disruption knowing that they may come under the litigation spotlight.

James Brady-Banzet, Lina Bensman and Delphine Michot are partners, Roberto Argeri is counsel, and Polina Lehmann is an associate, at Cleary Gottlieb Steen & Hamilton LLP.

© 2023 Thomson Reuters (Professional) UK Limited. This article first appeared in the March 2023 issue of PLC Magazine.