Feature

KEY POINTS

- A contract is frustrated when performance has become "radically different" due to an external event.
- The parties' contractual allocation of risk can exclude frustration.
- A borrower relying on frustration faces an uphill struggle.

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When COVID-19 infects finance contracts: frustration, *force majeure* and illegality

COVID-19 will often cause borrowers to breach their loan-to-value covenants or payment or other obligations. Certain risks making performance impossible or more burdensome will be provided for in the express terms, but something as specific as a pandemic such as COVID-19 will not. The borrower will naturally look for legal routes to suspend or otherwise evade its ongoing payment obligations. This article considers that situation.

INTRODUCTION

External events interfering with contractual performance are dealt with by general *force majeure* clauses (unusual in finance agreements, although present, eg in ISDA derivatives contracts) and the common law doctrines of frustration and supervening illegality. If successfully invoked, they lead to the automatic discharge of the contract, or at least its temporary suspension. Over a year into the pandemic, we now have COVID-19 case law (albeit much of it in lease disputes) to help guide those considering the application of those doctrines to the effects of the pandemic on a particular finance or other commercial contract.

THE "RADICALLY DIFFERENT" TEST OF FRUSTRATION

COVID-19 is unlikely to render a loan illegal or strictly impossible to perform, but a borrower may argue that the effects on its business mean that the purpose of the loan has been frustrated. Frustration occurs whenever, without either party's fault, performance of a contract has become "radically different" from the obligation undertaken (see *Davis Contractors Ltd v Fareham Urban District Council* [1956] AC 696 at [729] per Lord Ratcliffe), and borrowers may contend that this is true of their loan.

In *North Shore Ventures Ltd v Anstead Holdings Inc* [2010] 2 Lloyd's Rep 265 (appeal allowed on other issues: [2012] Ch 31) a company received a loan which was to be used to finance its meat and oil trading businesses, but a significant portion of the funds were frozen by the authorities. The loan was held not to have been frustrated because:

(i) only part (36%) of the funds were frozen (and a loan cannot be partially frustrated);
(ii) the borrower was still able to earn interest on the frozen funds and use them in foreign exchange transactions;
(iii) the freezing was the borrower's fault for sending the money to Switzerland, and most importantly;
(iv) although the money had been made available for a specified purpose, this was not the essence of the loan and was something with which the borrower alone was concerned (at [311]-[316]).

In short, even where a purpose for the funds is specified, the lender is in the business of providing money and the operation of the borrower's business is largely a matter for their own risk.

An application of this test in the COVID-19 context can be found in the lease case of *Wilmington Trust SP Services (Dublin) Ltd v Spicejet* [2021] EWHC 1117 (Comm), where a lessee under a ten-year lease of three aircraft sought to argue frustration and illegality as a result of a ban on operation due to design defects and COVID-19. The High Court held that the ban on operation resulting from the defective design of two of the aircrafts could potentially amount to frustration by rendering the lease not only more onerous but radically different – in circumstances where design issues, unlike operational matters, were not necessarily matters falling exclusively within the lessee's risk – but at the date of the lessor's summary judgment application, the ban had not been long enough by comparison with the duration of the lease (at [65]).

A limited period of COVID-19-related closure similarly prevented frustration of a lease in *Bank of New York Mellon (International) Ltd v Cine-UK Ltd* [2021] EWHC 1013 (QB), where it was confirmed that frustration (unlike *force majeure* clauses) could not temporarily suspend contracts, but only operated on a permanent irrevocable basis, hence the requirement for an event rendering performance radically different (at [211]). As to illegality, that doctrine could temporarily suspend the obligation performance of which had become illegal, but not the separate rent payment obligation (at [218]).

IMPACT OF CONTRACTUAL ALLOCATION OF RISK ON FRUSTRATION

As a general rule, if the parties agree how to deal with the impact of the occurrence of a particular event (by means of, eg a *force majeure*, MAC or cessation of business clause), the parties' contractual allocation of risk will take precedence over the doctrine of frustration. For example, in *Agrokor AG v Tradigrain SA* [2000] 1 Lloyd's Rep 497, a company bought milling wheat before certain export restrictions were introduced preventing its delivery by the seller. The contracts contained a clause specifically providing for the cancellation of the contract in the event of export restrictions being imposed, as well as a *force majeure* clause excusing liability for non-performance in the same case. Longmore J held that these clauses excluded frustration (at [33]).

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In *Salam Air Saoc v Latam Airlines Group Sa* [2020] EWHC 2414 (Comm), the lessee of an aircraft could not use it because of a COVID-19 travel ban in Oman. The lessee's obligation to pay rent was expressed to be "absolute and unconditional irrespective of any contingency whatsoever" including "the ineligibility of the aircraft for particular use or trade" (cl 8.2), and even if the aircraft became a "total constructive loss" (cl 21.3) or was requisitioned (cl 22). After examining the lessee's frustration case, Foxton J concluded that:

> "These clauses are … fundamentally inconsistent with any suggestion that regulations in Oman … or any long-term suppression of air travel even after such regulations had ceased to have effect, had the effect of terminating the Aircraft Leases and freeing SalamAir of its obligation to pay rent." (at [51])

A further relevant consideration in the court's view was the fact the leases gave the lessee the option to terminate if it ceased to carry on the business of air transport but only after the expiry of a four-year period (at [55]), expressly allocating most of the risk of the business becoming impossible or uncommercial to the lessee. Similarly, in *Wilmington Trust*, it was held that a clause providing that the lessee's payment obligations were "absolute and unconditional and shall not be affected or reduced by any circumstances" excluded the operation of frustration (at [62]).

The same approach was adopted in *Canary Wharf (BP4) T1 Limited v European Medicines Agency* [2019] EWHC 335 (Ch). The EMA was required to relocate its seat from London to Amsterdam following Brexit and argued that the lease of its headquarters in London had been frustrated. Marcus Smith J disagreed: although Brexit was a "seismic" event, which had not been foreseen by either party (at [241]), the EMA was contractually entitled to transfer the lease and it was therefore contemplated that the EMA could leave its premises (in accordance with the contractual terms dealing with transfer) (at [239]).

FORCE MAJEURE AND THE EXERCISE OF THE POWER OF DESIGNATION

The case of *Dwyer (UK) Franchising Ltd v Fredbar Ltd & Bartlett* [2021] EWHC 1218 (Ch) contained a form of *force majeure* clause in which the contract was suspended, although the franchisee of the plumbing business would make reasonable endeavours to resume trading (see [265]) and would keep the franchisor updated as to circumstances, if a *force majeure* event arose that prevented or hindered either party from complying with the franchise contract *and* the franchisor "designated" it as a *force majeure*. The High Court held (at [263]) that the franchisor was impliedly subject to a fetter that its designation discretion must be exercised honestly, in good faith and genuinely, and it must not be exercised arbitrarily, capriciously, perversely or irrationally, following the line of cases of which the modern leading decision is *Braganza v BP Shipping Ltd* [2015] 1 WLR 1661. In other words, in determining whether the franchisee was prevented or hindered from complying, the franchisor focused exclusively on turnover and demand for the plumbing services (which were key worker services and so not legally prohibited during the lockdowns) but should have taken into account the franchisee's personal circumstances, which required him to self-isolate (at [267]). This failure to exercise the discretion properly was held to be a repudiatory breach (at [272]), although the franchisee affirmed the contract.

Force majeure clauses are not common in loan agreements, however, so this decision is unlikely to have much impact on finance contracts, although analogous considerations may apply to the discretionary operation of MAC clauses.

MAC AND "CESSATION OF BUSINESS" CLAUSES

This article is primarily concerned with borrower routes to evade payment obligations, but it is necessary briefly to consider express clauses – typically favouring the lender – that can be triggered by COVID-19, because they provide part of the context within which the loan agreement must be construed when considering frustration. One category of clause that may be engaged is the "suspension of business" event of default. Another is the "material adverse change/effect" clause, which may be triggered by the effect of COVID-19 on the borrower's financial position, business, security or risks.

The model LMA documentation defines widely both "material adverse change" (any event which, in the lender's opinion, has or is reasonably likely to have a material adverse effect on, inter alia, the business of the borrower) and "cessation of business" (the suspension of all or a material part of the borrower's business except as a result of a permitted disposal). It is not difficult to think of situations where COVID-19 will trigger these clauses (and see *Travelport Ltd v Wex Inc* [2020] EWHC 2670, where a buyer sought to rely on a MAE clause following the outbreak of the COVID-19 pandemic to avoid their obligation to close the transaction).

Moreover, a lender would have a respectable argument that these clauses, especially cessation of business clauses, exclude the operation of frustration by allocating the risk of such events: by providing a right on the lender to terminate in the case of the borrower's business being impacted by external events, they may be said impliedly to provide that the borrower has no right to escape in such circumstances (cf the consideration of *Agrokor AG* and *Salam Air Saoc* above). It remains to be seen whether that argument, coupled with the lender's generally not taking the risk in relation to what the borrower does with the money (see *North Shore Ventures Ltd* above), will always be enough for lenders to resist borrower arguments of frustration. ■

Further Reading:

- MAC clauses and contractual discretion (2020) 10 JIBFL 659.
- COVID-19 and suspension of business/operations events of default clauses (2020) 11 JIBFL 756.
- LexisPSL: Banking & Finance: News: Coronavirus (COVID-19), force majeure and frustration: Key legal principles and industry implications.