Dispute Resolution Hotline

March 23, 2020

IMPACT OF COVID-19 ON CONTRACTS: INDIAN LAW ESSENTIALS

Executive Summary: The unforeseen Covid-19 pandemic has severely impacted contractual performance across the globe. Companies would believe that desperate times call for desperate measures. Maybe, or maybe not. As the legal clichй goes, "it depends". In case of contractual performance, it will depend on a factual and legal analysis of the underlying contracts.

Domestic and international businesses have approached us to address legal issues arising out of Covid-19. We have also received queries relating to recourse to litigation and arbitration for breach of contract. Through this article, we attempt to focus on the impact of Covid-19 on performance of contracts, governed by Indian law, and sets out practical considerations that could help businesses in these tough times.

"*The day is gone" the learned Judge of the Court of Appeal went on to say, "when we can excuse an unforeseen injustice by saying to the sufferer 'it is your own folly, you ought to have put in a clause to protect yourself. We no longer credit a party with the foresight of a Prophet or his lawyer with the draftsmanship of a Chalmer. We realise that they have their limitations and make allowances accordingly. The old maxim reminds us that he who clings to the letter clings to the dry and barren shell and misses the truth and substance of the matter. We have of late paid heed to this warning, and we must pay like heed now*".

And yet, the House of Lords expressed disapproval of the way in which the law was stated above with respect to unforeseen events and contractual obligations, and said, "*it is a matter of construction of the contract*".

The unforeseen coronavirus pandemic has interrupted our personal, professional, financial and commercial lives, to a point of preventing best performance at all levels; even rendering performance impossible. This article focusses on impact of Covid-19 on performance of contracts, governed by Indian law. In the context of lines quoted above from an English judgment,[1] we assess whether impossibility of performance under Indian law is purely a matter of construction of respective contracts, and if so, can businesses salvage their obligations and save their contracts.

Through this article, we hope to help companies re-look at their contracts carefully, and assess the extent to which their performance can either be excused without liability or compelled with the force of law. While doing so, we also shed light on impossibility of performance in contracts governed by the oft-chosen English law, and what factors could be considered by English courts or tribunals in situations such as these.

I. IMPOSSIBILITY OF PERFORMANCE AFTER EXECUTION OF CONTRACT

Covid-19 has either made performance difficult or impossible. It has caused commercial hardship to some parties in performance of their contractual obligations, while rendering others completely incapable of performance.

Impossibility of performance after execution of a contract is provided for under Section 56 of the Indian Contract Act, 1872 (ICA). Section 56 occurs in Chapter IV of the ICA which relates to performance of contracts and purports to deal with one category of circumstances under which performance of a contract is excused or dispensed with. It provides:

"*Section 56. Agreement to do impossible act—An agreement to do an act impossible in itself is void.*

Contract to do act afterwards becoming impossible or unlawful—A contract to do an act which, after the contract is made, becomes impossible, or, by reason of some event which the promisor could not prevent, unlawful, becomes void when the act becomes impossible or unlawful.

Compensation for loss through non-performance of act known to be impossible or unlawful—Where one person has promised to do something which he knew, or, with reasonable diligence, might have known, and which the promisee did not know, to be impossible or unlawful, such promisor must make compensation to such promisee for any loss which such promisee sustains through the non-performance of the promise." (emphasis supplied)

At first blush, the statutory provision emphasized in para 2 of Section 56 would appear to come into play fully in the Covid-19 scenario. However, would this 'impossibility' of performance sweepingly render every contract void under Indian law, from the date of the impossibility? What is the ambit of 'impossibility' and who is best placed to determine it? How is risk allocated in such situations? Does any provision in the ICA permit parties to save their contracts from being void automatically? The concepts of contingent contracts, force majeure and frustration are relevant to understand the nuanced remedies available to parties under their contracts in the Covid-19 scenario.

A. Impossibility & Force Majeure

Majority of the contracts expressly contain a term according to which the contract would stand suspended or discharged on the happening of certain circumstances. In such cases, the dissolution of the contract would take

Research Papers

From Capital to Impact: Role of Blended Finance
June 15, 2024

Opportunities in GIFT City
June 14, 2024

Start-up Governance Essentials
May 30, 2024

Research Articles

Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy
January 25, 2024

Private Equity and M&A in India: What to Expect in 2024?
January 23, 2024

Emerging Legal Issues with use of Generative AI
October 27, 2023

Audio

Why is the ad industry unhappy with MIB's self-declaration mandate?
June 18, 2024

Incorporation of arbitral clause by reference: Position in India and other Asian Jurisdictions
June 12, 2024

Third-Party Funding: India & the World
April 27, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Future of India-Mauritius tax treaty – Impact of new Protocol on M&A deals and Private Equity structures
April 23, 2024

place under the terms of the contract itself. Although in English law these cases are treated as cases of frustration as detailed in Part B below, in India they would be dealt with under section 32 of the Indian Contract Act which deals with contingent contracts or similar other provisions contained in the Act. Section 32 of the Indian Contract Act is provided below:

"*32. Enforcement of Contracts contingent on an event happening - Contingent contracts to do or not to do anything if an uncertain future event happens, cannot be enforced by law unless and until that event has happened. If the event becomes impossible, such contracts become void.*"

There may be situations where the unforeseen event may render performance impossible only during the limited time in which the event is in operation, thereby providing a window for resuming normal contractual obligations after the event ceases to operate. The concept of *force majeure* comes into play in such situations.

According to Black's Law Dictionary, the term '*force majeure*' means an event or effect that can be neither anticipated nor controlled.[2] It is used with reference to all circumstances independent of the will of man, and which, it is not in his power to control and such force majeure is sufficient to justify the non-execution of a contract. A typical force majeure clause in contracts reads as below:

"*None of the Parties shall be liable for any delay, failure in performance, loss or damage due to Force Majeure events. During the performance of the Agreement events of Force Majeure may occur, such as, but not limited to, war, fire, flood, earthquake, accident, riot, strike, explosion, lockout, act of God, act of Government authority, accidents and/or damage, decisions from the Customer, or any event beyond the reasonable control of any of the Parties, which by their effects render impossible or hinder the performance of any obligation or the exercise of any rights under this Agreement or the normal operation of the Company's industrial installations, or cause the failure or omission to comply with this Agreement.*"

Under English law, *force majeure* is a contractual provision under which a party is entitled to cancel the contract or is excused from performance upon the occurrence of specified events beyond the party's control. The key factor is to establish a direct link of causation between the event and the impossibility of performance in order to demonstrate that the event is the sole cause of inability of the party to perform under the contract.

Under Indian law, akin to English law, force majeure derives its existence from the contract. The basis of this clause is to save the performing party from consequences of breach arising from an event over which it has no control. It is therefore an exception for breach of contract. Whether force majeure can be invoked to excuse liability for non-performance would depend on the nature and general terms of the contract, the events which precede or follow it, and the facts of the case.

In a situation envisaging force majeure, it is upon the party to elect to invoke the force majeure clause in the contract in order to excuse itself from performance under the contract.

In light of Covid-19, on February 19, 2020, the Ministry of Finance issued an Office Memorandum on 'Force Majeure Clause' providing that "*coronavirus should be considered as a case of natural calamity and force majeure may be invoked, wherever considered appropriate, following the due procedure (in the Office Memorandum)*".[3] It provides that "*a force majeure clause does not excuse a party's non-performance entirely, but only suspends it for the duration of the force majeure. The firm has to give notice of force majeure as soon as it occurs and it cannot be claimed ex-post facto…If the performance in whole or in part or any obligation under the contract is prevented or delayed by any reason of force majeure for a period exceeding ninety days, either party may at its option terminate the contract without any financial repercussion on either side*".

Although parties to aforesaid contracts ought to honour the Office Memorandum, it may not serve as a binding document. If a dispute arises with respect to acceptance or rejection of the Office Memorandum, it will depend on the Court or the arbitral tribunal to interpret the force majeure clause and assess if the same covers any provision for evidence in terms of certificates or office memoranda as above in order to prove a case of force majeure.

B. Impossibility & Frustration

Impossibility and frustration are often used as interchangeable expressions.[4] However, it is important to understand that the common law doctrine of frustration as propounded in English law is distinct from the statutory provision of supervening impossibility and illegality under Indian law. This affects the manner in which contracts will be interpreted distinctly under English law and Indian law.

Under English law, frustration is so much concerned with the change in circumstances that it cancels the base of the contract as a whole or in case of performance makes it different with that which was in consideration by the parties in the beginning and is concluded by the legal order.[5] In order to excuse oneself from impossibility of performance under an English law governed contract on account of Covid-19, the party will need to prove frustration of contract. Does a particular contract make room for application of the doctrine of frustration depends on legal theories formulated by English courts. These involve (a) implying terms into the contract; (b) vesting courts with power to determine what is just and reasonable under certain circumstances; (c) engaging in construction of the contract based on intention of parties.

However, under Indian law, the statutory provision under Section 56 sets out a positive rule of law on supervening impossibility or illegality that renders performance impossible in its practical, and not literal sense.[6] Relief is given by the court on the ground of subsequent impossibility when it finds that the whole purpose or basis of a contract was frustrated by the intrusion or occurrence of an unexpected event or change of circumstances which is so fundamental as to be regarded by law as striking at the root of the contract as a whole. The contract would then automatically come to an end.

The court undoubtedly would examine the contract and the circumstances under which it was made. The belief, knowledge and intention of the parties are evidence, but evidence only on which the court has to form its own conclusion whether the changed circumstances destroyed altogether the basis of the adventure and its underlying object. In such a sense, frustration merely becomes a sub-set under the larger doctrine of supervening impossibility. Indian courts will apply Section 56 objectively to assess whether a particular situation has rendered performance

Q&A 2024 Protocol to the Mauritius India Tax Treaty
April 22, 2024

Boost to India's Space Potential: India Liberalizes Foreign Direct Investment
April 03, 2024

impossible and frustrated the contract, without delving into party intention, justness and reasonableness etc.

Under Indian law, the doctrine of frustration is an aspect or part of the law of discharge of contract under Section 56 by reason of supervening impossibility or illegality of the act agreed to be done. While Section 56 envisages impossibility of performance leading to avoidance of the contract, it does not statutorily encapsulate the concept of unforeseen contingencies which result in temporary suspension of performance and resumption of the contract. The concept of force majeure comes into play in such situations. Unlike a force majeure clause where the non-performing party needs to elect or choose to invoke the clause, either by means of a notice or otherwise, frustration of contract under Section 56 operates automatically from the date of the impossibility and puts the contract to an end.

Since the ICA is exhaustive upon impossibility of performance under Section 56, it would not be permissible to import the principles of English law on doctrine of frustration and legal theories, de hors these statutory provisions. Under Indian law governed contracts and disputes, the decisions of the English Courts would possess only a persuasive value and may be helpful in showing how the English courts have decided cases under circumstances similar to those which have come before Indian courts.

Thus, frustration of contract is an aspect (and not the be-all) of Section 56, where performance is absolutely impossible and the contract comes to an end automatically from the date of impossibility. In the event an unforeseen event renders performance impossible, Parties will need to assess if the event has resulted in a destruction of the object and purpose of the contract, or has caused a fundamental difference in the way the contract now stands, far beyond the contemplation of the parties.

II. PRACTICAL CONSIDERATIONS

A. Assessment of impact of Covid-19

The first and foremost step before evaluating the remedy is to assess the impact of Covid-19 on the business and performance of contractual obligations. Has Covid-19 resulted in partial failure of performance, complete incapability to perform, delays which if extended beyond a tolerable limit could strike at the root of the contract, or mere commercial hardship?

For instance, parties to an executable contract may be faced, in the course of carrying it out, with a turn of events which they did not at all anticipate, a wholly abnormal rise or fall in prices which is an unexpected obstacle to execution. This does not in itself get rid of the bargain they have made. It is only when a consideration of the terms of the contract, in the light of the circumstances existing when it was made, showed that they never agreed to be bound in a fundamentally different situation which had unexpectedly emerged, that the contract ceases to bind. A party may not be absolved from the performance of its part of the contract merely because its performance has become onerous on account of an unforeseen turn of events. Thus, not every case of affected performance is fit for claiming frustration.

In terms of a force majeure clause, the clause could contain words that indicate the extent of impact on performance to invoke the clause, such as ‘prevent’, ‘hinder’, ‘delay’. Courts have interpreted the words ‘prevent’ and ‘hinder’ differently. In addition, Courts have also construed words which precede or follow words such as ‘hinder’ or ‘prevent’ in the clause, as well as construed the nature and general terms of the contract to determine if the impact as claimed by a party enables it to invoke the agreed force majeure clause.[7] The meaning of these words is critical to understand if a party can invoke the force majeure clause.

The ICA provides remedies based on the effect of an unforeseen event on the contractual performance. Impact-assessment is therefore essential to better inform the parties about the remedies they can seek under Indian law.

B. Does your contract offer a remedy?

If your contract does not contemplate the occurrence of an event that renders the performance of the contract impossible or illegal, and the event occurs, the remedy might lie in Section 56 of the Contract Act. However, a claim of frustration It will be beneficial for parties to seek legal advice on establishing or defending a claim based on frustration of contract, as this will involve an analysis of factors such as the impact of the event, the object of the contract etc.

In contrast, Section 56 could have little application where parties expressly contemplate in the contracts, the recourse to be adopted by them in the event there is any change in circumstances or an occurrence of an event that renders it impossible for the parties to perform the contract. To the extent that the parties have already contemplated the consequences of a supervening event in their contract, the same would remain binding on the parties.

For instance, it is open for the parties to agree that if on account of any force majeure condition it is impossible to perform a contract, a party would compensate the other for the efforts made notwithstanding that it is impossible to fully perform the same. In such cases, the contractual provisions would prevail over the plain language of Section 56 of the Contract Act. However, such claims can be defended on several counts, one being failure to meet the notice requirement.

Similarly, if the parties have contemplated the possibility of an intervening circumstance which might affect the performance of the contract, but have expressly stipulated that the contract would stand despite such circumstances, there can be no case of frustration because the basis of the contract would be to demand performance despite the happening of a particular event. It could be difficult to excuse performance in such cases. Nevertheless, defences are available to parties seeking to excuse non-performance, one of them being unequal bargaining powers between the parties to the contract.

In some cases, where parties may have expressly provided for the case of a limited interruption through force majeure, but a supervening event renders performance indefinitely impossible for an indefinite period, a party could make a claim for frustration of the contract. To assess whether Covid-19 could trigger the relevant force majeure clause, or frustrate the contract, it will be critical to evaluate the operational aspects of the relevant commercial transaction and the type of force majeure clause in the contract.

C. Other Terms of Contract

Contracts might contain distinct terms dealing with consequences of non-performance. For instance, a contract might contain a provision on liability on account of delays, or price escalations. In the event delay or price escalation occurs due to occurrence of the force majeure event, one would need to assess not only the language of the force majeure

clause but also specific contractual provisions relating to delays, in order to invoke the appropriate clause for resting their remedy. In such cases, it will be important to assess if the consequences of non-performance due to the unforeseen event were in fact contemplated by the parties or it was a risk that the parties knowingly undertook and agreed to cover in the agreement.

D. Formal requirements

In a potential case of force majeure, contracts may require fulfilment of formal requirements by a party proposing to excuse itself from non-performance. For instance, a contract may require a party to issue a notice informing the other party that a force majeure has been triggered by the occurrence of an event covered under the force majeure clause. During the operation of the force majeure event, a party might be required to report or consult regularly with the other party. A party may also be required to show proof of mitigation and estimated timings for dealing with the particular event of force majeure. An instance of a force majeure clause with notice requirements is provided below:

"The Party suffering a Force Majeure event shall:

a. inform without delay the other Party by notice, giving details of the Force Majeure event;
b. inform the other Party when the Force Majeure event is at an end and resume performance of this Agreement forthwith thereafter unless the Parties have decided otherwise.

Should the hindrance, impossible performance, or delay resulting from such Force Majeure event persists beyond a period of ninety (90) calendar days, and the Parties have failed to reach an agreement or find means to overcome the Force Majeure event, then any of the Parties may request the termination of the Agreement by way of a notice."

E. Can a Force Majeure clause be interpreted to cover a 'Pandemic'

The term 'Act of God' is often seen in force majeure clauses in contracts. Act of God is defined as an extraordinary occurrence or circumstance, which could not have been foreseen and guarded against, either due to natural causes, directly and exclusively without human intervention; and which could not by any amount of ability have been foreseen, and if foreseen, could not have been resisted. This could include floods, hurricanes, earthquakes etc.

However, force majeure is held to have a more extensive meaning than the oft-seen 'Act of God' term, and includes occurrences such as strikes, riots, wars, breakdown of administrative machinery, lockdowns, and effects of such events such as shortage of supply owing to war, war-time difficulty in shipping, refusal of export license etc. Some force majeure clauses could contain generic terms such as "any other happening".

Whether a pandemic such as Covid-19 can be interpreted as an 'Act of God'? Whether the effects of shutdowns due to Covid-19 trigger the force majeure clause in contracts? As stated above, this would depend on the language of the clause and the rules of legal interpretation of force majeure clauses.[8]

F. Best endeavours or a duty to mitigate

A contract could place a duty on performing party to mitigate the effect of its non-performance on the other party. This duty could be contained in a 'best endeavours' clause. In order to successfully invoke a force majeure clause to excuse liability for non-performance, a party under a contractual duty to mitigate or make best endeavours will be required to demonstrate the efforts it undertook to mitigate the impact of its non-performance. An instance of a force majeure clause with a duty to mitigate is provided below:

"The Party suffering a Force Majeure event shall remedy the situation, with all possible dispatch and use of its best efforts to minimize the effects thereof, insofar as it is possible and/or appropriate."

G. To terminate or not to terminate?

The effect of frustration or force majeure could both result in termination of contract, depending on the terms of the contract. In fact, we have seen cases where a contract containing a force majeure clause was sought to be terminated on the grounds of frustration of the contract, despite the two remedies being mutually exclusive. Thus, under what circumstances can a contract be suspended, what would be the requirements to bring about suspension, would a party need to elect a remedy by express notice, what circumstances could result in extension of suspension to a level of termination, when can termination be sought on grounds of frustration despite presence of a force majeure clause - would depend entirely on the nature and terms of the contract. Businesses would need to thoroughly scrutinize the contract to assess the remedies available to the parties.

H. Renegotiation:

However, in cases where the performance has merely become commercially more difficult but not impossible, parties could consider whether it would be commercially viable to suspend the contract, or use this opportunity to renegotiate the contract. Some parties may also consider this as an opportunity to put an end to a bad bargain by assessing its options to terminate the contract.

I. Risk Allocation & Restitution:

In most of the cases where performance of a contract becomes impossible, the party that has received any advantage under such contract at the time when the agreement is discovered to be void, is required to restore such advantage to the person from whom the same was received. This is expressly enacted under Section 65 of the Contract Act. However, this is not an absolute rule. The extent of restitution will depend on a case to case basis, involving an analysis of several factors, such as expenses incurred by the non-breaching party.

Further, parties to contract are free and can expressly provide that the risk of supervening events shall be borne by one of them, or apportion it, or deal with it in various ways such as suspension of performance, compensation, refund, restitution or discharge.

J. Dispute Resolution:

Ultimately, if a Party fails to agree on the event being a Force Majeure event, or fails to comply with the provisions of the Agreement under the applicable Force Majeure provisions, or attempts to establish a claim of frustration of contract in presence or absence of a force majeure clause, parties will need to look into the contract and assess legal

risk and remedies in terms of litigation or arbitration of the dispute arising out of such disagreement. Some contracts could cover such an eventuality specifically, for example:

"*Nothing contained in this clause shall prevent any of the Parties from referring the question of whether or not an event of Force Majuere has occurred or whether or not this Agreement shall be terminated due to the Force Majeure event, to arbitration under Clause [_].*"

III. CONCLUSION

As would be evident, the aforesaid considerations are heavily fact-specific and contract-specific. As quoted in the opening paragraph of this piece, Lord Denning J. stated that parties cannot be expected to have 'foresight of a Prophet, or his lawyer with the draftsmanship of a Chalmer'. However, Justice Viscount in appeal denied the role of Courts in implying terms and what is just and reasonable into the contract, and categorically stated that the fate of the parties depends 'on the construction of the contract'. Desperate times such as that of the Covid-19 pandemic may not justify desperate measures by parties. As the law stands, parties will need to closely look at their contracts.

In addition to contractual language, it will also be critical to understand the commercial operations and transactions of the company in the relevant industry and sector, to understand the ambit of contractual clauses dealing with impossibility of performance. For instance, in the realm of mergers and acquisitions, a clause that is similar to force majeure and protects parties from unforeseen adverse changes in circumstances is the Material Adverse Change clause. While assessing whether the Material Adverse Change clause can be invoked in a particular situation such as the Covid-19, it will be necessary to assess the aforesaid practical considerations in the context of mergers and acquisitions, for instance, the impact of Covid-19 on the transaction, the language of the Material Adverse Change clause and whether it offers a suitable remedy, formal requirements, recourse to other remedies under contract such as termination or share price formulas.

Further, judicial interpretation of contracts in disputes involving unforeseen events is writ large with diverse and nuanced approaches, highly dependent on the nature of the contract and the language of the terms. It is therefore prudent for parties to seek legal advice and conduct a thorough legal analysis of their contracts to protect themselves on either side of performance, allocate risk properly, formulate a strategy for renegotiation if required, and save the sanctity of contract.

– Kshama Loya Modani & Vyapak Desai
You can direct your queries or comments to the authors

[1] *British Movieto-news Ltd. v. London and District Cinemas Ltd. L.R.*, (1951) 1 K.B. 190, Court of Appeal decision; reversed in appeal by the House of Lords.

[2] Black's Law Dictionary, Edition 11 (2019)

[3] Office Memorandum No.F. 18/4/2020-PPD titled 'Force Majeure Clause', issued by Department of Expenditure, Procurement Policy Division, Ministry of Finance.

[4] *Satyabrata Ghose vs. MugneeramBangur and Others*, AIR 1954 SC 44, paragraph 10.

[5] Chitty on Contracts, Volume I, (31st Edition), Sweet & Maxwell

[6] *Satyabrata Ghose vs. MugneeramBangur and Others*, AIR 1954 SC 44, paragraph 17

[7] Energy Watchdog vs. Central Electricity Regulatory Commission and Others, 2017 (4) SCALE 580.

[8] Mulla & Pollock on Indian Contract Act, 1872 & Specific Relief Act, 1967, page 1181