

Brexit: The Contractual Aftershocks

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Commercial Litigation

While the UK's decision to leave the EU could bring about significant changes to the UK's legal and economic landscape, we cannot yet know how wide-ranging these changes will be. It is generally agreed that the changes will be fairly dramatic if the UK is unable to negotiate a deal that will maintain its access to the single market, or if the eventual deal brings an end to the free movement of people.

If the UK's trading relationship with the EU changes materially, commercial parties may find themselves bound by long-term contracts that they no longer consider commercially favourable. To give two simple examples, a business that relies on goods imported from the EU may be subject to new trade tariffs or a business that uses cheaper migrant labour may be forced to pay for more expensive domestic labour, both of which could significantly reduce profit margins. One can readily anticipate more complex but analytically equivalent scenarios across many sectors that are heavily regulated by the EU, such as financial services and life sciences.

As the situation develops, parties should consider whether changes to legal or economic conditions brought about by Brexit could trigger an entitlement to terminate some contracts, or render them unenforceable.

This alert considers the potential application of a number of contractual doctrines to a post-Brexit scenario and, in particular, the following: (i) the doctrine of frustration; (ii) force majeure or material adverse change ("MAC") clauses; and (iii) the possibility of a contract being declared unenforceable on grounds of public policy/illegality. The application of these doctrines, and the degree to which they may affect existing contracts, will necessarily depend heavily on the nature and extent of any changes brought about by a Brexit.

Historically, the English courts' willingness to allow parties to "walk away" from, or renegotiate, contracts has been very limited. The English courts are traditionally seen as upholders, rather than destroyers, of bargains. Merely showing that a deal is less profitable than it was previously is unlikely to be sufficient to justify termination or grounds for suspension/renegotiation.

Frustration

The English doctrine of frustration applies where an event occurs after the contract has been entered into that either (i) renders the performance of the contract impossible; or (ii) renders the contract radically or fundamentally different from what was initially agreed. If a contract is frustrated, the parties are released from any further performance of the contract. Since no party is at fault, "the loss lies where it falls" and no damages can be claimed as a result of the non-performance of the other party. It may be possible to recover money paid before the contract was frustrated under the Law Reform (Frustrated Contracts Act) 1943.

The English courts apply this doctrine with caution and are wary of allowing parties to rely on it to get out of what they (now) perceive as a bad bargain. A party will have to do more than show that the contract is less economically favourable as a result of Brexit. It will have to demonstrate that the changes brought about by Brexit are so great as to render the contract radically or fundamentally different. It follows that the concepts of radical and/or fundamental changes are likely to feature as the key battlegrounds in any dispute regarding frustration.

The English courts have, however, held a contract to be frustrated when a change in the law renders its performance impossible. Following this precedent, if, for example, a financial institution entered into a loan facility agreement pre-Brexit relying on the EU's "passporting" regime, but the "passporting" regime was discontinued post-Brexit and the institution was no longer lawfully able to perform its obligations under that facility agreement, it could have a strong argument that the contract had been frustrated.

There is, however, an important qualification to this: a party may generally not rely on the doctrine of frustration where the alleged frustrating event was, or should have been, foreseen by the parties as a real possibility. Accordingly, the knowledge of the parties at the time they entered into the contract is potentially significant. Brexit has arguably been foreseeable as a possibility since David Cameron promised the referendum in January 2013 or possibly even earlier. The closer the start of the contract to the date of the referendum, the stronger the argument is likely to be that the parties should have foreseen at least the possibility of Brexit.

Force Majeure and Material Adverse Change (MAC) Clauses

A force majeure clause is a contractual provision that protects the parties from unexpected events that are outside of their control. Depending on the clause in question, the parties may be permitted to suspend, vary, or terminate the obligations of the contract, following the occurrence of a force majeure event.

Whether or not events triggered by Brexit will fall within the scope of a force majeure clause will depend on the precise wording of the clause. Force majeure clauses generally contain a list of example events, such as natural disasters, strikes, or wars. The standard contractual interpretation rule of *eiusdem generis* provides that Brexit will be within the scope of the clause if it is of the same "type" or "genus" as the events listed in the contract's force majeure clause. If the list includes, for example, "major changes to the legal or economic landscape," a force majeure argument might succeed. However, in the absence of specific wording such as this, parties are unlikely to be able to rely on force majeure clauses. Indeed, there is established English precedent that changes to market or economic conditions, even if they make a contract less profitable or unprofitable, do not constitute a force majeure event.

MAC clauses are commonly found in public offer, M&A, and finance documents. They allow a party to be released from their obligations in the event of a material adverse change to the business of the borrower/target company.

As with force majeure clauses, MAC clauses usually contain a long list of events that will constitute a material adverse change. Whether or not a party can rely on a MAC clause will depend on the wording of the clause in question. Indeed, there have been reports that in the lead up to the Brexit, companies have been adding specialist Brexit MAC clauses to their contracts.

As with the doctrine of frustration, a party may not be able to rely on a force majeure or MAC clause if the event in question was foreseeable, and so the same considerations regarding the timing of when the contract was negotiated and executed will apply.

Illegality/Public Policy

Under English law, a contract can be declared unenforceable if it is illegal or contrary to public policy. A contract can either be illegal under statute (e.g., sections 26 to 30 of the Financial Services and Markets Act 2000 provide that contracts pertaining to a regulated activity and made by an unauthorised person will be unenforceable against the other party) or under common law (e.g., if the terms of the contract require the commission of an illegal act, it will not be enforceable).

Taking again the financial services “passporting” example discussed above, the financial institution might argue that since it is against the law for it to carry out its obligations without the EU “passport,” the contract should be declared unenforceable for illegality. Although this argument is potentially effective, this doctrine is generally reserved for cases that “engage the public interest” (i.e., criminal or quasi-criminal cases), and a frustration argument would, at least analytically, be a more likely approach.

Key Takeaways

It is too early to say whether Brexit will give rise to the sorts of drastic changes that would trigger disputes of the type discussed in this alert. Parties will have to wait until any legislation ending the UK’s membership enters into effect, or at least until negotiations with the EU have reached a sufficiently advanced stage that there is relative certainty as to the form the UK’s future relationship with the EU will take.

However, businesses should be prepared for all eventualities. The first step will be to consider how changes brought about by Brexit could affect the functioning and/or profitability of long-term contracts. Parties who fear that they might be affected should then consider whether these changes to their contracts could be sufficiently serious to constitute a frustrating event and/or whether their contracts contain a suitable force majeure or MAC clause. Where the form of Brexit adversely impacts the economics of a long term contract, it may be possible to use some of the arguments outlined in this note to renegotiate more favourable commercial terms.

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