Risk, Resilience and Reputation

Contractual obligations under the microscope

CMS webinar briefing

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Risk, Resilience and Reputation Webinar Series

*The concluding webinar in our **Focus on Funds | Risk, Resilience and Reputation** series sees CMS partners **Walter Gapp**, **Tim Sales** and **Jodok Wicki** assess the significance and implications of contractual obligations. The full recording is available here.*

Macro disruption, rising prices and impaired supply chains always propel contractual obligations to front of mind.

We have plenty of such scenarios in the western world today.

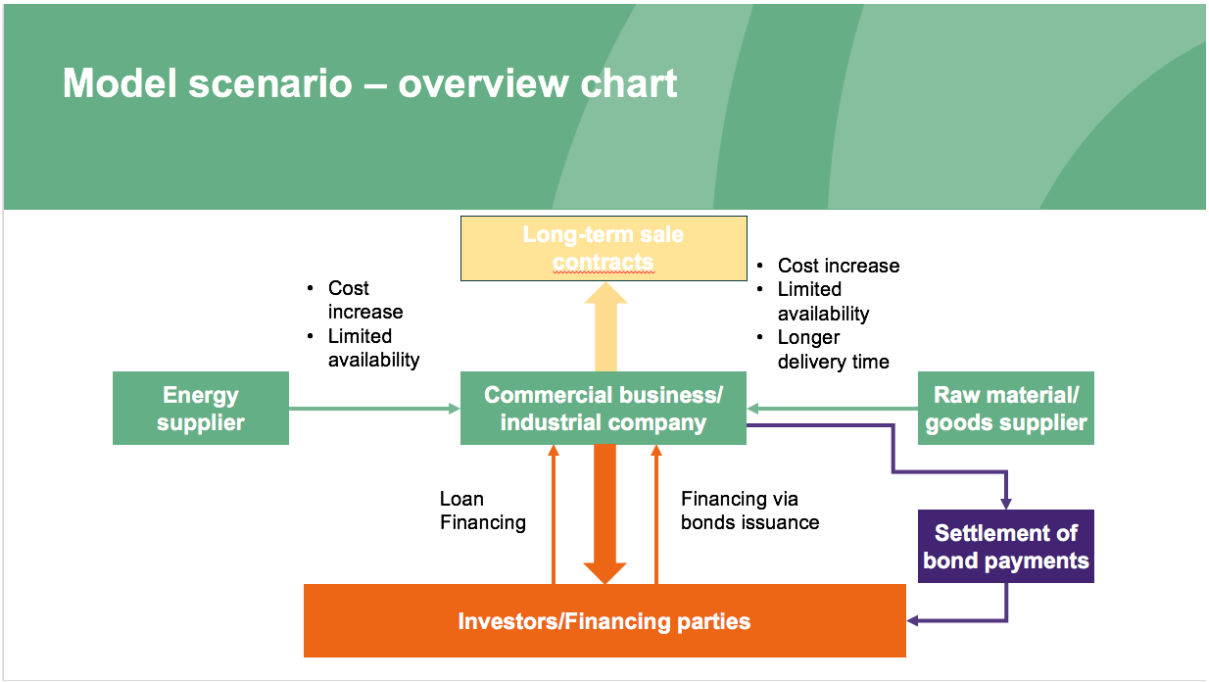
And, unsurprisingly, companies managing investment funds will be keen to establish their position should any agreements with investee companies enter difficult territory.

It's probably worth looking at the two sides of contractual obligations from the investee company's perspective. Both have the potential to affect investments in that company.

The investee's relationship with its suppliers and clients

First, much of a company's focus will be on their suppliers and customers. After all, these comprise the lifeblood of an organisation.

In the diagram below, a hypothetical industrial business is set up as a fund structure with refinancing via loans and bond issuance. Given the macro picture, the company is exposed to increased financial pressure – thanks to higher energy bills and less predictability about its raw materials.



Such problems may compel the company to seek indemnities for breach of contract or terminate contracts with suppliers. In turn, the latter might wish to seek justification or terminate contracts.

This creates a risk that payments up the financing chain will be delayed – in breach of contractual obligations.

Under Swiss law, for example, judges will look for a range of factors. The first question always being: have the parties addressed the changed circumstances, directly or indirectly? Is there an adjustment clause (by law or by contract)? And does the contract have to be adjusted?
Essentially, a contract is void if its terms are impossible, unlawful or immoral. However, where the defect pertains only to certain terms of a contract, those terms alone are void.
This may also concern subsequent impossibility: An obligation is deemed extinguished where its performance is made impossible by circumstances not attributable to the obligor. In a bilateral contract, the obligor thus released is liable for the consideration already received pursuant to the provisions on unjust enrichment and loses his counter-claim to the extent it has not yet been satisfied.

In the case of our hypothetical industrial company, it could face subsequent impossibility if, say, the small number of suppliers it relies on in Russia have been nationalised.

The question of compulsion of contractual obligations will be assessed ultimately under an abuse of law test, i.e. considering also good faith in business conduct. Circumstances where insisting on compliance with contractual obligations would be considered can thus open a possibility for contract adjustment. This is a key point of difference to English common law.

Contractual obligations with investors

Sticking with the diagram above, its bottom half shows a financing arrangement comprising loans and bonds.

The financing part of the equation is governed, at least in England and Wales, by the primacy of the contract. This means any court will look at the intention of the parties when they entered into the contract – giving the words their natural and ordinary meaning in the context of the document as a whole, the parties' relationship and the relevant "factual matrix" as known to the parties.

Commercial common sense is a factor to be taken into account, but this cannot undervalue the importance of the words used.

Given one role of lawyers is to think creatively around such issues, much focus is more recently placed on force majeure.

If our hypothetical company is suffering problems because its suppliers are suffering problems, the contract may include some specific terms that could trigger force majeure. This could include supply chain issues that genuinely affect commercial performance over time.

Broader economic factors are, absent specific provisions, not a trigger for force majeure. Just because a contract has become more expensive to perform, even dramatically more expensive, this is not a reason to relieve a party on the grounds of force majeure.

In recent months we have seen companies, startled by rising prices, start to insert explicit terms around pricing and costs in new contracts.

In instances where force majeure is not available to the investor, what else might they and their counsel consider?

Three potential options are:

- Illegality, where it is no longer lawful to fulfil an obligation under a contract due to a change in law, the contract may well have specific provisions address this – relieve a party of performance obligations and addressing the consequences that flow from this (including, potentially, termination);
- Impossibility, where something is genuinely and permanently impossible; and
- Frustration, a narrow concept – giving rise to repayment of money paid under the contract less some expenses.

Any risk of delays in payments made up the financing chain, such as coupons to bondholders, is likely to trigger a breach of contractual obligations. Fund investors have three options.

The first is to insist on performance and sue for a breach if payment is not made. A business might push back with force majeure or frustration but, ultimately, it's very difficult for the business to legitimately avoid payment.

Secondly, if the business is genuinely unable to make payment, the investor might be able to accelerate payment obligations and seek to call in their investment. They might cite a material adverse change (MAC) clause – and these are common in loan arrangements.

They might also sue for damages – seeking payment plus interest.

They may exercise termination rights, which typically arise (amongst other scenarios)in the event of a default. However, a common pitfall is not observing the correct procedure – which is usually an opportunity for the other side to claim you have repudiated the contact. They will they then turn the tables and sue for damages.

Thirdly, there are sanctions. It is not uncommon for a fund to be limited in making payments to certain bond investors due to sanctions limitations.

This is the famous – at least in legal circles – Council Regulation (EU) No 833/2014. It is one of the centrepieces of sanctions regulation in the financial services world. In essence, the issuer might be able and willing to pay but some central clearing systems may be prevented from forwarding the money to certain, sanctioned investors.

Our hypothetical company faces real world difficulties.

But the problems arising from its contractual obligations are not always intractable. There is frequently a creative, reasonable and workable solution for funds.