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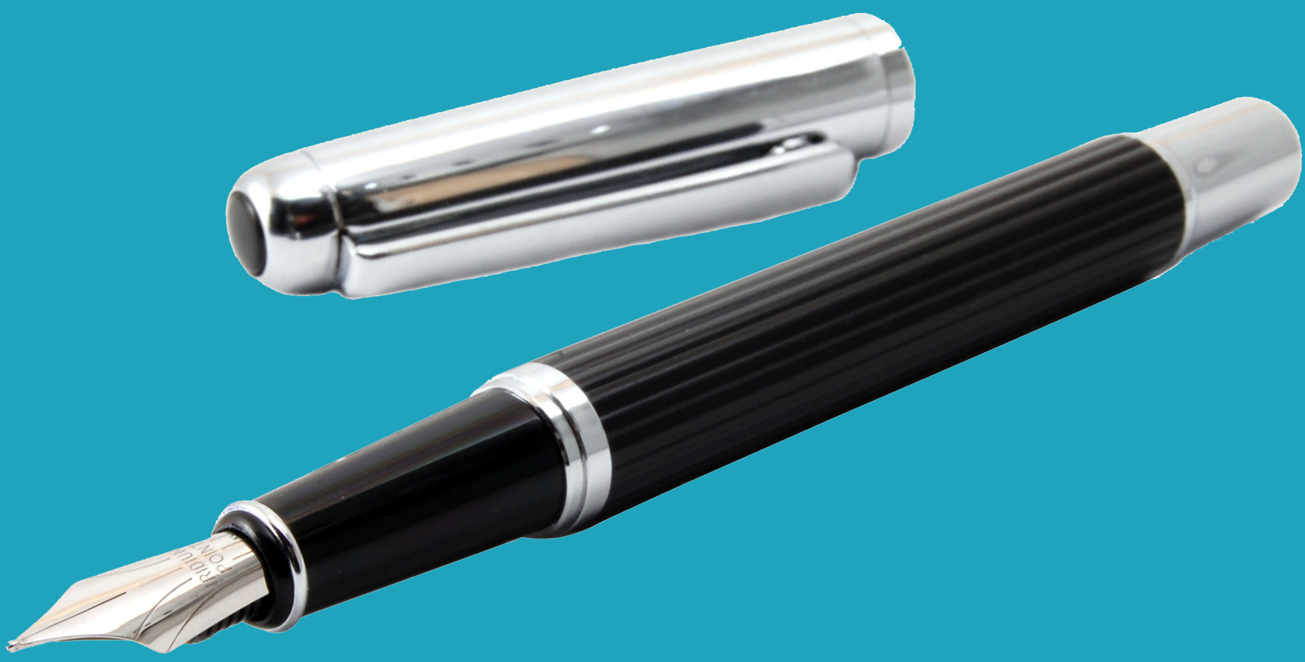
Advising the Board on **Contractual Risk**

Reports looking at the full range of commercial risk



Risk, Resilience and Reputation

Directors' risk report

For the board, contractual relationships form the backbone of business interactions. From internal office provisions to key supplier and customer relationships, contracts govern the terms upon which business is carried out. Written contracts create opportunity for clarity of precisely who is going to do what in the relationship and provide security and reassurance if the other party does not do what they committed to.

Properly crafted contracts enable parties to allocate risk between them. They set out the rights and obligations of the parties, clarify what is expected, record the responsibilities assumed and define the scope of potential consequences for the parties should any issues arise. The better the drafting of the contract, the more clearly the risks are defined and exposure to possible negative consequences is confined.

A board that is on top of their key contractual risks, pro-actively managing them, may sleep easily at night. In contrast, the directors of a company exposed to significant risk in its key contracts, which is not being effectively and pro-actively managed may well be faced with an inability to deliver on their own obligations, exposure to significant claims, and potentially personal liability.

Stakeholder risk thermometer

HIGH RISK

Directors
failing to manage contractual risk effectively can cripple a business and, at its extreme, lead to personal liability for directors

Employees
often with the greatest influence on day-to-day risk management of contracts, employees are on the ground negotiating the details, agreeing terms, and managing delivery

Clients/Customers
well managed contracts with clear and fair terms keep customers and clients coming back; poorly managed contracts which are not delivered on time and to budget do the opposite

Suppliers
when not managed well can create significant contractual risk, impacting delivery to clients and customers and increasing exposure to contractual risk

Shareholders
will lose out if contractual risks are not appropriately managed and mitigated

LOW RISK

Key contractual risks

No written agreement in place at all

Contracts can (and frequently do) exist without the agreed terms being written down in one document. This creates a whole world of uncertainty and risk for businesses. The process of determining the terms of a contract in the absence of a written agreement often requires painstaking examination of emails, notes of phone calls and other records to determine whether or not a contract has been formed and where and when its exact terms have been recorded. It also increases the risk of a party inadvertently binding itself to a contract, for example by its actions, even where it only intended to reach an understanding on the scope of the negotiations by agreeing preliminary matters. In virtually all cases, a written agreement is the best route to providing clarity and mitigating risk.

The parties to the agreement

In many instances, contracts are entered into with specific identifiable parties for particular reasons. Often, it is important that the relationship is with company x and not with company y, making sure that the contracting company is capable of performance and, if it doesn't perform, ensuring adequate protection is in place. In multi-party contracts, the board should therefore ensure that rights and obligations are owed to (and by) the correct parties. For example, payment obligations adopted by a parent company with delivery obligations assumed by a local subsidiary.

If the identity of a party is particularly important, careful consideration should be given to rights of assignment and/or novation, where both the benefit and the burden of a contract may be transferred. The outset of the contractual relationship is also the best time to consider the impact of any insolvency event of one of the parties – considering whether to include parent company guarantees or specific termination rights in the event of, or prior to, any insolvency event.

Contracts management

Having agreed terms and signed the contract, focus then shifts to delivery. Whilst every effort may have been made at the outset to provide for all eventualities, circumstances can change necessitating amendments or variations to the agreed terms. This is often a key risk area for the board, particularly where changes or variations are informally agreed at an operational level, but are not known to contracts managers, the legal team or the board, giving rise to significant risk of legal disputes down the track.

Long term supply contracts often contain detailed and prescriptive change control processes which need to be followed for changes to become effective and for those changes to flow into other obligations, for example payment (or the right to receive payment).

Historically, there was real ambiguity about the effectiveness of "no oral variation" clauses, which, on their face, required any amendments or variations to the contract to be made in writing. Helpfully, the Supreme Court has provided some clarity, such that properly drafted contractual provisions should be able to mitigate the risk of contracts being inadvertently varied orally where the contract provides for variations solely through an agreed process.

Liability

A key risk area for the board with any contract is the potential exposure of the parties, should something go wrong. Any party is well advised to consider the extent that liability might be appropriately limited and to engage in the drafting of relevant terms early on. Any provisions seeking to limit liability should be clear and specific. Broad and general sweeping exclusions are far less likely to be upheld by the courts, with any exclusion or limitation of liability interpreted narrowly.

There are certain liabilities that cannot be limited (for example, those arising from fraud). The board should also be aware that clauses that seek to exclude or limit liability arising out of breach of contract, negligence or misrepresentation must satisfy the "*reasonableness*" test in the Unfair Contract Terms Act 1977, namely that: *the term shall have been a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made.*

Unlawful/unenforceable provisions

No board wants to find itself in a position where the key contractual provision that they wish to rely on turns out to be unenforceable under English or Scottish law. Any provisions that are incapable of performance without contravention of law will generally be considered unenforceable. This could include a scenario where, for example: required licences or permits have not been obtained; performance would contravene competition law; restrictive covenants in place amount to unlawful restraint of trade; agreements relating to future business would breach procurement law if complied with; or liquidated damages provisions amount to unlawful penalties.

Whilst the impact of unenforceable obligations may be mitigated to an extent in circumstances where the specific provision can be severed from the other provisions of the contract, parties are well advised to give careful consideration to the enforceability of key contractual obligations at the outset.

What if a party can't perform its obligations?

If a party has agreed to perform obligations under a contract, they are generally expected to do so. If they don't perform, they will be in breach of the contract and the default remedy is damages to put the innocent party in the position they would have been in had the contact been performed. Where damages would not be an adequate remedy, for example where the continued supply of services are critical for ongoing operations, a business may be able to obtain a court order for specific performance, requiring the other party to perform its contractual obligations for at least a period of time, for example, until another supplier can be put in place. In some instances, either because the contract expressly provides, or the breach goes to the heart of the contract, the innocent party may be able to terminate the contract resulting in potentially serious consequences for the board to deal with. This can be the case even where something happens outside of the party's control, which renders performance impossible.

In very limited circumstances, a party may be released from their obligations in the event of impossibility of performance where the contract has been "frustrated". However, the bar is very high – the event must be so fundamental that it strikes at the root of the contract in a manner that was beyond the contemplation of the parties, rendering performance impossible. The fact that, for example, performance would now be far more expensive (making the contract commercially unviable) would not be sufficient.

It is for this reason that force majeure clauses are common. Whilst a force majeure clause generally won't be implied into a contract, an express provision specifying what will amount to an event of force majeure, together with the consequences of the same, can often prove a lifeline for the board where the company is unable to comply with its contractual obligations for reasons outside of its control. As always, the devil is in the detail, particularly as the courts have recently confirmed that it is not enough for a force majeure event to be a cause of the failure to perform – it must be the sole cause.

Dispute resolution

In the honeymoon period of finalising a contract, mechanisms for resolving disputes may not be high on the agenda. But for a board, they provide a critical means for controlling and managing any disputes that may subsequently arise.

Staged escalation processes are common-place and will be well known to most directors. The question then arises, what law governs the contract and where should any disputes ultimately be resolved? Across Europe, properly drafted applicable law and jurisdiction clauses are generally enforced without issue. However, whilst Brexit should not affect parties' choice of law, it might affect the approach that Member States take to respecting English or Scottish jurisdiction clauses and recognising and enforcing English or Scottish judgments. If no partnership agreement is entered into between the UK and the EU, formal obligations giving effect to English or Scottish jurisdiction clauses and the need to recognise and enforce English or Scottish judgments throughout the EU will create some uncertainty. The severity of this will be apparent once the exact terms of any partnership deal are determined.

Regardless, the English or Scottish courts are expected to remain an attractive forum for resolving international disputes, especially given the expertise and independence of the judiciary; the speed and predictability of proceedings and depth of judicial precedent. However, if the risk of judgments becoming less readily enforceable in EU Member States is a material concern to the board, options such as arbitration (which remains unaffected by Brexit) should be considered.

Exit

The final aspect of contracts that creates considerable risk for a board is the end – what happens when the parties part company and how does a board manage the risks involved?

Contracts can come to an end for a variety of reasons including by agreement, a unilateral right of termination, expiry of the term of the contract, insolvency or breach. Boards are well advised to carefully consider the possible eventualities with key contracts to ensure: consistency of supply, appropriate transition to new providers of services, transfer and/or destruction of confidential information and data, and cessation of access to systems.

The risk or threat of termination is often wielded as the sword of Damocles over a contracting party. Well drafted, clear termination provisions setting out precisely when and how termination can be effected can cut through this and alleviate the impact of any threat. Boards are well advised to ensure that any termination provisions are carefully followed - purported exercise of a right to terminate a contract in circumstances where no such right exists (or where the right was not exercised correctly) can create even greater issues.

Watch this space

A new international standard for the management of legal risk (ISO 31022), encompassing contractual risks, has recently been approved by the member countries of the International Standards Organisation (ISO). ISO 31022 is the first ever international standard in this area and is intended to be used for all kinds of organisations. ISO view this Standard as important given that the effective management of legal risk is central to sound corporate governance and plays an important role in strategic decision making as well as daily operations. This ISO Standard is scheduled to be published in late May 2020. The co-convenor of the ISO Working Group which developed ISO 31022 was CMS partner Dr Sam De Silva.

Contractual risk and Covid-19

The current Covid-19 pandemic is having unprecedented impact around the globe. At the forefront or everyone's mind, rightly, is the personal challenge and even tragedy faced by many. However, in the business world Covid-19 is having a significant impact on contractual arrangements and risk, putting many arrangements in commercial jeopardy. At the heart of most questions faced by the board is the impact that Covid-19 is having and will continue to have on obligations owed to (or by) businesses, and the allocation of risk and responsibility between the parties.

The reasons that contractual arrangements are at risk are likely to be varied, and may include Government restrictions preventing events from taking place or certain businesses operating, issues with supply chains and third party services, or a lack of employees or customers. In all these cases, key information that the board to will want to consider includes:

— can the business be relieved from performance (either permanently or temporarily) under the terms of the contract(s) in place;
— the consequences that follow from temporary or permanent relief from performance (for example, whether the business will be required to pay any sums (if itself relieved from performance) or will receive payment of sums (where others are relieved from performance of obligations otherwise owed to the business)); and
— if the relevant contract doesn't give the outcome the business needs, whether there is scope to renegotiate contractual terms, providing a better outcome than being found to be in breach of contract and required to pay significant sums to the other party.

The starting point in all of this is the contract itself. There are three broad bases upon which a business may be relieved of contractual obligations and which the board should be giving consideration:

Force majeure – if not previously familiar with this term, board members will no-doubt now have heard much about force majeure and its potential implications in the context of Covid-19. If there is a force majeure clause in the contract, this may provide a lifeline to the board and the business in temporarily (or potentially permanently) relieving the business from its obligations where the business is prevented from performing for reasons outside of its control. Each clause will turn on its own specific terms and it is therefore important for any board to consider the terms carefully. However, generally speaking, in order to rely on a force majeure clause, a board will usually need to demonstrate (as a minimum) that:

— the particular circumstances fall within the scope of the clause;
— the reason that the obligations cannot be performed is outside of the business' control; and
— the business has complied with the formalities for invoking force majeure (including with respect to timing).

The consequences of any force majeure event will usually be specified in the contract and will likely include a temporary suspension of obligations and identify the impact on other obligations (including, for example, payment). If force majeure events continue, this may then also lead to a right of termination (either pursuant to the terms of the contract itself or potentially at common law).

Frustration – if force majeure is not an option, either because there are no relevant terms in the contract or because the circumstances are not covered by the force majeure provisions that exist, all is not necessarily lost. If the board can demonstrate that through no fault of its own, a contractual obligation has become incapable of being performed because the circumstances are radically different from those existing when the contract was entered into, it is possible that the contract may be treated as having been frustrated. The bar for a board to overcome is a very high one. However, we can envisage that Covid-19 could render the purpose of a contract frustrated in some circumstances, for example, where the contract relates to a one-off event which has been cancelled. Whilst future obligations will be discharged, any pre-payment where no benefit has been derived will generally be required to be returned (subject to some deduction for expenses incurred). If there has been no pre-payment, but some benefit has been enjoyed by the other party, payment may be required by that other party.

Illegality – for completeness, whilst likely to affect very few contracts, if the law completely prohibits performance of a contract (rather than simply making it more difficult or more expensive), generally speaking, the contractual obligations will be discharged. The consequences that follow, for example regarding pre-payment, involve a balancing exercise of the respective parties' interests and public policy.

For further information specifically related to contractual risk in the context of Covid-19, see **https://cms.law/en/gbr/publication/renegotiating-or-cancelling-commercial-arrangements-in-light-of-covid-19**

Summary: practical risk management for directors

Select the right party: in key contracts, ensure board input into the selection of suppliers, including consideration of potential alternatives should issues arise down the track.

Appropriately scope your role: ensure that your business can actually do what it has signed up to do and that suppliers can do the same.

Limit your liability: carefully consider and appropriately limit liabilities in order to mitigate the exposure to your business.

Pro-actively manage: create a culture of pro-active management of contracts, flagging and resolving issues at an early stage before they escalate and the risk profile grows.

Effectively resolve disputes early: make effective use of dispute resolution mechanisms the norm within your business, using appropriate escalation provisions to ensure that, wherever possible, disputes are resolved efficiently and effectively to allow the business to focus on its core objectives.

Plan your exit: scope out your exit as you enter – planning at the outset will significantly reduce the risk later down the path.

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