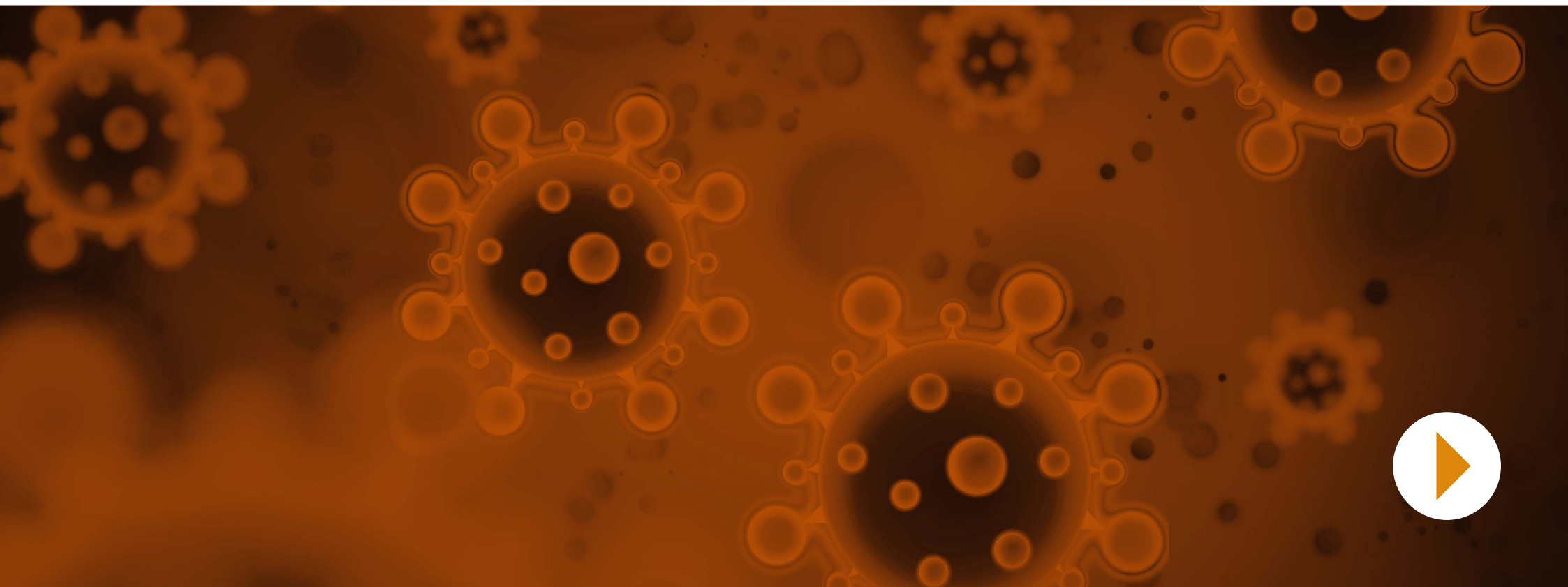
Bird & Bird

COVID-19 & Your Air Transport and Aerospace Supply Chain

A Ten Step English Contract Law Guide



COVID-19 and the Air Transport and Aerospace Sector

The impact of COVID-19 on the airline industry and the reduction in demand of air travel is expected to have a material long-term impact on our industry. Airlines across the world have grounded the majority of their fleets, with some no longer operating any aircraft at all. Not only does IATA's recent forecast indicate that airlines will need more than $200 billion in bailout money to sustain operations beyond July, but numerous commentators suggest there will be a much leaner airline sector in the medium term after operations resume.

It is not only the airlines that are struggling from lack of demand. Airline suppliers and the whole air transport supply chain are reliant on continuing to deliver new equipment and supplying spare parts and maintenance services. All major commercial aircraft programmes depend on a global supply chain for raw materials and components, as well as an available workforce to physically build aircraft and engine parts and operate and maintain production facilities, final assembly lines and test facilities.

Whilst some Chinese production facilities are at various stages of restarting and ramping back up capacity, production across the rest of the globe is still being hindered and disrupted. Examples of the practical impacts COVID-19 is having in the aerospace supply chain are:

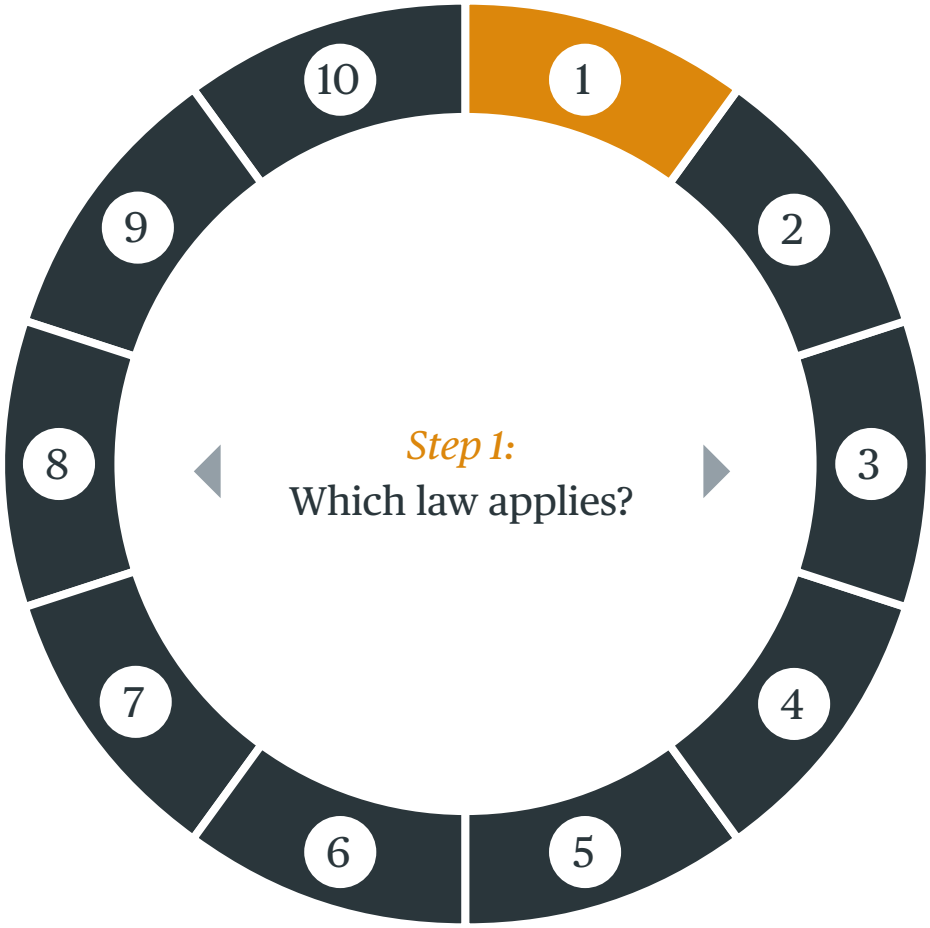
- *Imports/Exports stopped* - countries are enacting different measures concerning import of goods and services from COVID-19 high risk countries. The European Commission has allowed each Member State to adopt proportionate measures aimed at safeguarding the health of its citizens and to prevent the spread of COVID-19.
- *Production and test facilities closing/reducing output* - countries are adopting differing approaches as to whether or not production must halt, and this is changing almost daily. Airbus has been forced to pause production in Spain and France in order to comply with COVID-19 restrictions. And in the US, Boeing has also ceased production at its Washington state twin-aisle aircraft factory for reasons connected with the virus.
- *Reduced workforce* - employees not coming to work due to self-isolation, sickness or fear of risks.
- *Travel bans* - border closures mean that overseas-based specialists who are required to travel to work (for example, for specialist installation or operation and maintenance) are unable to get to the location of work due to these travel restrictions.

Additionally, many airlines now take their equipment on the basis of long term support contracts. Airlines make payments - and suppliers rely on payments - based on hours flown, which in the current climate are drastically reduced. Airlines rely on aircraft and engine performance and reliability guarantees from suppliers and these guarantees are dependent on the commitments the airline made regarding operational utilisation of the aircraft/engine over several years (e.g. 10 or 12 years). These contracts can entitle the suppliers to alter the charges or reduce the guarantee support if an airline customer reduces its utilisation or fails to take delivery of the planned fleet.

This all means that customers and suppliers are keen to understand their rights and liabilities under their contracts should COVID-19 cause delay, should COVID-19 cause delay or otherwise have an impact on the nature or performance of the contract and, equipped with this knowledge, will be better placed to work collaboratively to find solutions. Of particular interest may be whether liquidated damages remain payable by the supplier, and whether the supplier has any other options such as suspension, termination or entitlement to increased costs under the change in law clause.

This note focusses on how force majeure and frustration under English contract law applies to the COVID-19 pandemic, and highlights other contractual hints and tips that both customers and suppliers should consider in the current climate.

Click to start ten step guide



In assessing whether or not a party is entitled to relief from its obligations, it is important to check both:

1. the governing law of the applicable contract; and
2. the laws in the jurisdiction where the obligations are being performed (particularly with regards to any mandatory restrictions in place regarding imports/exports, production and travel bans).

For example, the contract may be governed by English law meaning the language of the contract will be interpreted under English interpretation principles. However, the obligations under the contract may be physically performed in Italy (for example at a production facility or testing site) meaning the Italian law governing whether or not production must be suspended will be relevant to test the impact of the force majeure event (see steps 4 & 5 below).

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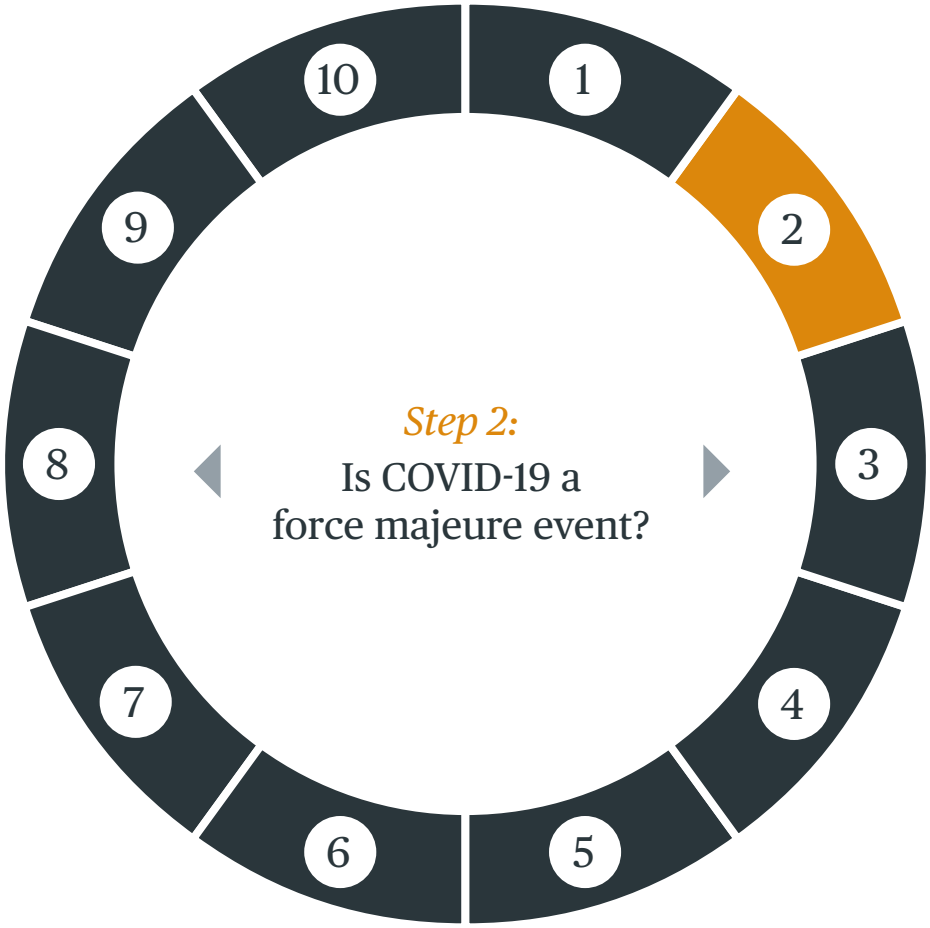

Step 2:

Is COVID-19 a force majeure event?

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Force majeure is a contractual mechanism that is only available if expressly set out in the contract. Unlike civil law jurisdictions, English law has no statutory provisions governing force majeure, nor will force majeure be implied into contracts under English law.

The language of a force majeure provision will be interpreted in line with existing interpretation principles under English law and there is precedent regarding the meaning of particular phrases. The English Courts will focus closely on the contractual language used such that each case will turn on its own facts and the contractual interpretation of the relevant term.

In the absence of any contractual force majeure clause (or other assistance that is provided by the contractual terms), a party could try to rely on frustration to avoid its contractual obligations (see step 9 below).

Force majeure clauses tend to follow two different formats:

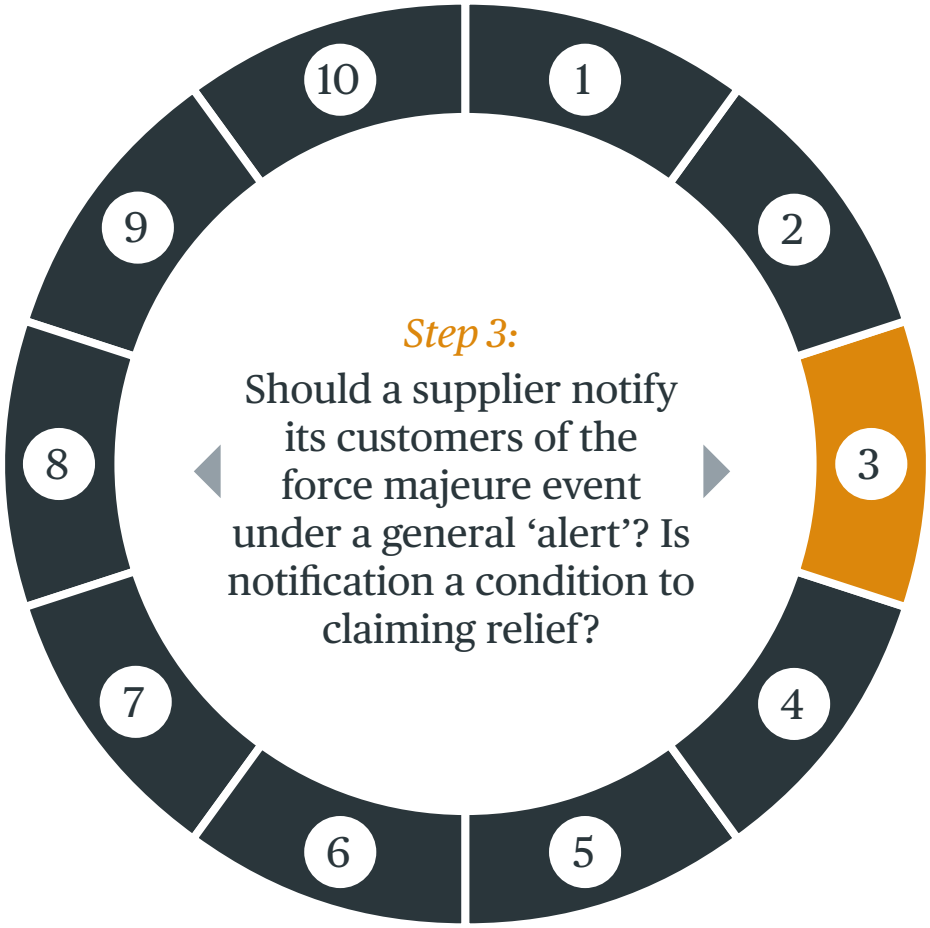
- *Option 1 -* An exhaustive list of events; or
- *Option 2 -* A statement that a force majeure event is any event beyond the reasonable control of the affected party, followed with a non-exhaustive list of events which shall be considered to be force majeure.

If the contract follows option 1 - some exhaustive force majeure clauses will contain specific wording relating to disease or epidemic or pandemic. However, if pandemic is not expressly listed, other events that may be applicable to COVID-19 include:

- "shortage of supplies or raw materials" - where the downstream impact of the COVID-19 is limited availability of supplies/raw materials in the market as a whole, not just from a party's contractual or preferred supplier;
- "labour shortages" - where workers are unable to man factories because they are off work due to sickness or self-isolation; and
- "Act of Government" - where an order by the Government or a government agency in a country has caused the disruption.

If the contract follows option 2 then, on the face if it COVID-19 is an event beyond the affected party's reasonable control. In either instance note:

- Even if COVID-19 is on the face of it a force majeure event under the contract, it does not automatically follow that the impact on business is beyond reasonable control and the affected party will still need to comply with the remaining steps below in order to claim relief; and
- You should ask if the affected party is claiming COVID-19 as the force majeure event, or another event that may have arisen as a result of COVID-19 (for example factory closure, lack of workforce). This could be important for when notice obligations are triggered (see step 3 below) and how long the force majeure event is set to continue (COVID-19 may continue for months whereas shortage of supplies may be shorter term).



Step 3:

Should a supplier notify its customers of the force majeure event under a general 'alert'? Is notification a condition to claiming relief?

The affected party may feel there are benefits, from a relationship perspective, of flagging up the force majeure event and the delay it has caused. It may wish to serve a general alert or early warning notice to its customers that COVID-19 is causing it delay/disruption and that it is doing whatever it can to mitigate this. Parties affected by COVID-19 sending these notices should be wary that:

- A general 'alert' may not satisfy the force majeure notification requirements in the contract as more factual detail is likely to be required; and
- A general alert may 'set the clock ticking' that the affected party considers the event to be a force majeure event, meaning formal notice should be served under the contract within the specified time period.

The contract is likely to require that the affected party serves notice of the force majeure event within a specified period. This may be drafted as a contractual obligation to serve notice, or as a condition to claiming relief. Look out for words/phrases such as "provided that" or "conditional upon" - these may indicate that if the affected party fails to serve notice within the required time period it loses its right to claim relief. The affected party must follow the requirements of the notice provision meticulously including who the notice should be addressed to, how it should be sent and information it needs to contain.

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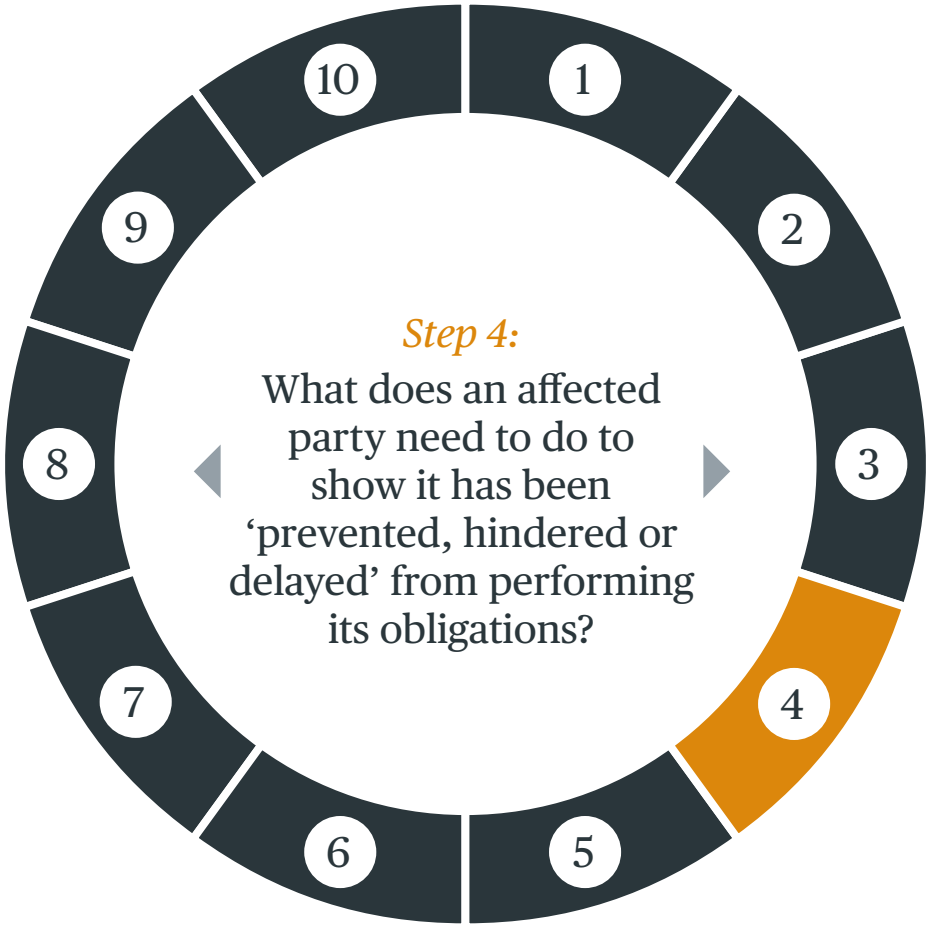

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Once a force majeure event has been established, the steps an affected party has to follow to claim relief will depend on what the contract says. Generally we find the affected party has to show:

1. the occurrence of one of the events referred to in the clause (see step 2); and
2. it has been prevented, hindered or delayed from performing the contract by reason of that event.

Prevent - Preventing performance means that it must have become physically or legally impossible, not merely difficult. For example, a supplier would have to show that the government in the applicable jurisdiction has mandated its factory ceases operation (through legislation or binding guidance). So far, governments are not generally mandating that manufacturing should stop. The affected party must also show that it was “ready, willing and able” to perform its obligations under the contract and it was the force majeure event which impacted performance.

Delay - Delay has a wider scope and may be easier for an affected party to establish. The supplier will still need to establish that as a result of the force majeure event, performance of its obligations is taking longer (or finishing later) than planned. The clause may require the delay to be the direct result and the affected party will still need to comply with the remaining steps below in order to claim relief.

Hinder - similarly to delay, this has a wider scope and may be easier for an affected party to establish. Hindrance may not be merely financial, case law makes clear “the fact a contract has become expensive to perform, even dramatically more expensive, is not a ground to relieve a party on the grounds of force majeure”[1], unless the contract specifically addresses this. The clause may require the hindrance to be the direct result and the affected party will still need to comply with the remaining steps below in order to claim relief.

[1] Thames Valley v Total Gas, High Court, 2005

The affected party must show it has taken *"all reasonable steps"* to avoid the operation of the force majeure clause or to mitigate its consequences[2]. This is an implied duty which applies, in all apart from exceptional situations, even if the contract contains no express clause requiring the affected party to mitigate the impact of the force majeure event.

It will be a question of fact as to whether an affected party has taken steps to mitigate the impact, but relevant factors could be:

- Assuming the stop in production has not been mandated by law in the applicable jurisdiction, what could the affected party have done to keep producing during COVID-19 (e.g. protective measures, redeploying staff, recruiting additional staff)?
- Could the affected party have conceivably switched suppliers - e.g. used an alternative shipping company that was still running?

The fact that the above measures may be more expensive does not matter. *"A mere difficulty or additional expense is not a sufficient ground"* for the force majeure provisions to be invoked[3], and the English courts are particularly alive to attempts to use force majeure provisions to avoid performance for economic reasons. Therefore, just because a contract has become more expensive as a result of COVID-19, or even uneconomic, to perform, that will not always constitute a force majeure event.

[2] Channel Island Ferries v Sealink 1988 1 Lloyds Rep 323.

[3] B&S Contracts v Victor Green 1984 ICR 419, (427(D)).

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Step 6:

If I am entitled to force majeure 'relief', what does this actually mean under the contract?

An entitlement to force majeure relief generally means (1) that the affected party is excused from contractual liability, including damages, in relation to its non-performance (or delay); and (2) either party may terminate the contract where the force majeure event continues for a defined period (usually 3 months plus). Relief could include:

1. relief from liability for liquidated damages with an extension of time to delivery dates;
2. relief from breach of contract claims for non-performance; and
3. relief from termination for default.

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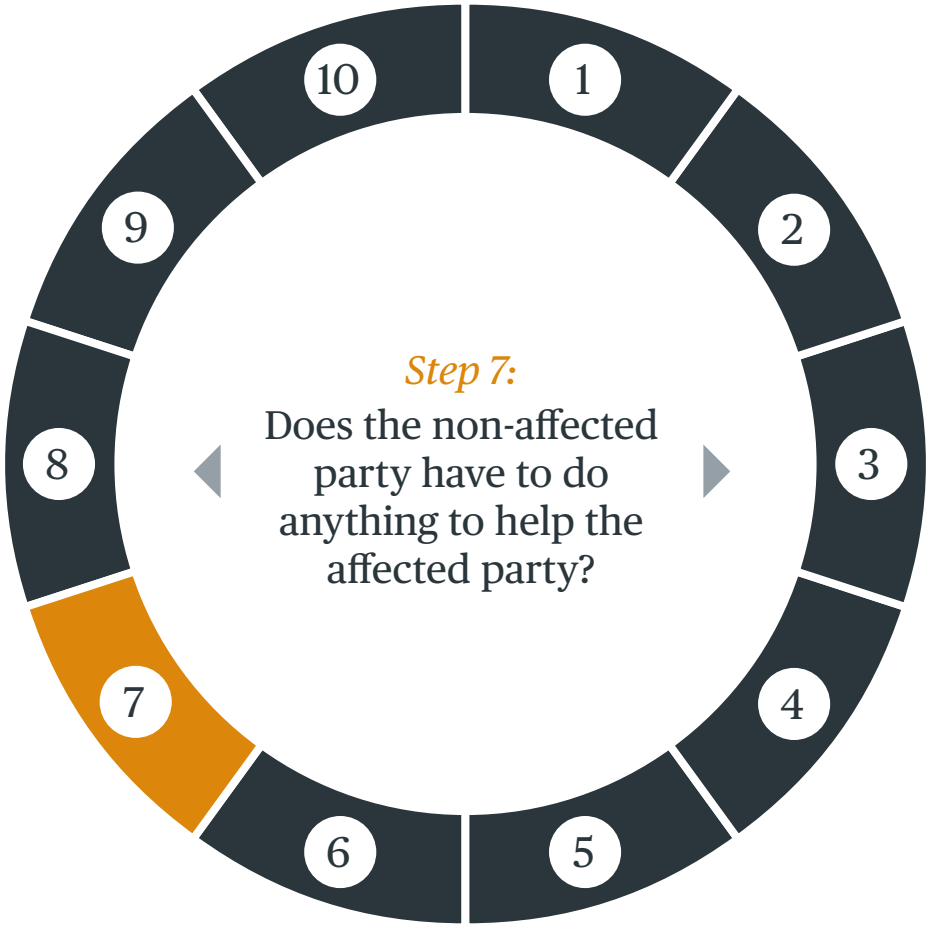

Step 7:

Does the non-affected party have to do anything to help the affected party?

This will depend on the contract. The non-affected party may have a contractual obligation to help the affected party to mitigate the impact of the force majeure event.

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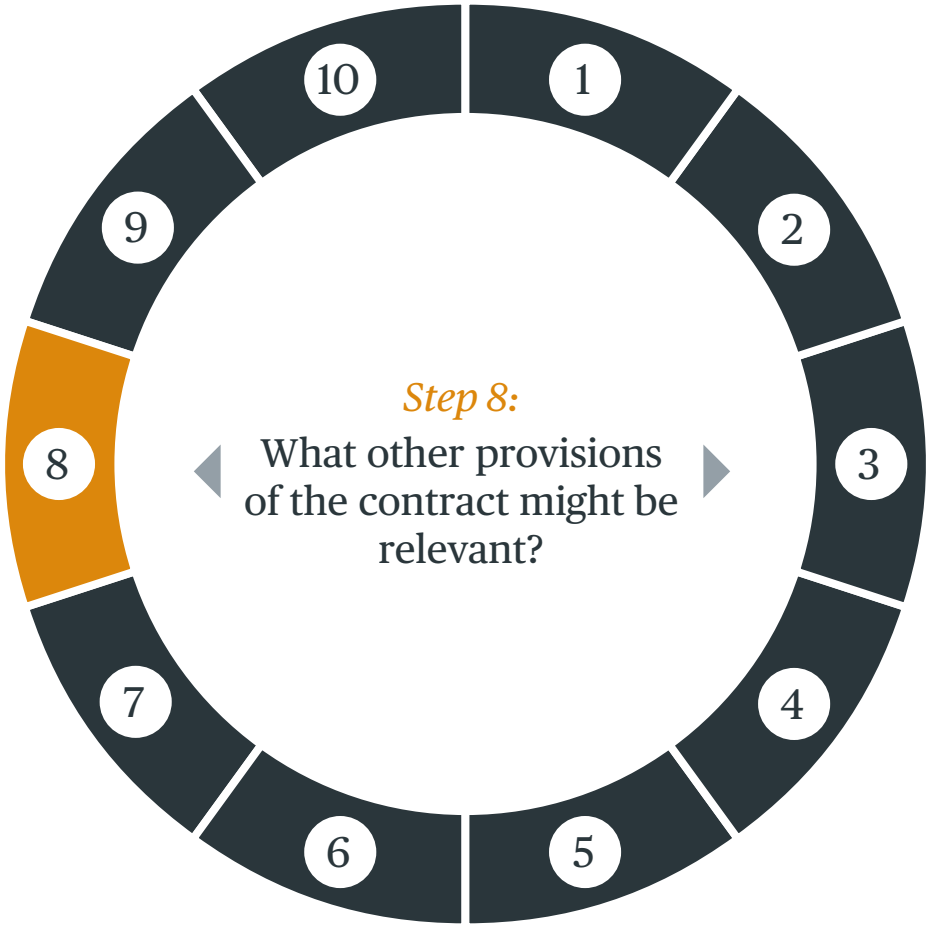

Step 8:

What other provisions of the contract might be relevant?

We suggest taking a holistic view of the entire contract. The following clauses may be particularly relevant -

- *Payment* - are there any rights for the customer to withhold payments if obligations are not performed (even if due to force majeure)?
- *Suspension/hardship* - are there any rights for the affected party to suspend its performance (for example due to economic change or under an express 'hardship' clause)?
- *Termination* - is any compensation payable for termination for force majeure?
- *Change in Law* - many countries are introducing new laws to deal with COVID-19 which could make performance of obligations more expensive. How is this risk dealt with? How is "applicable law" defined for the change in law clause and does this cover guidance and legislation? For example, if a factory is in Italy and Italian law impacts the costs of performance, does this still trigger a change in law price adjustment if the contract is governed by English law?
- *Excusable Delay* - could any of the reasons for a delay in supplier performance be an 'Excusable Delay' (as defined in the contract) entitling the supplier to some relief?
- *Material adverse effect* - are there any clauses entitling a party to terminate the contract if there is an event that has material adverse consequences or means that the contract would be loss making?
- *Health & safety* - can the supplier still comply with health & safety regulations and guidance that it may be contractually bound to comply with?
- *Key personnel* - are specified people earmarked for particular obligations?
- *Notice clause* - ensure compliance in order to ensure that notices are valid and can be relied upon.
- *Variations* - any amendments agreed due to COVID-19 will need to be made in accordance with any variations clause (which may require variations to be in writing).
- *No waiver* - a no waiver clause does not necessarily protect a party from post-breach inaction. A non-breaching party should still reserve its rights and remedies and notify the party in breach by formal contractual notice.
- *Dispute resolution* - which may include an escalation clause which includes parties' agreement to resolve any dispute on a staged basis.

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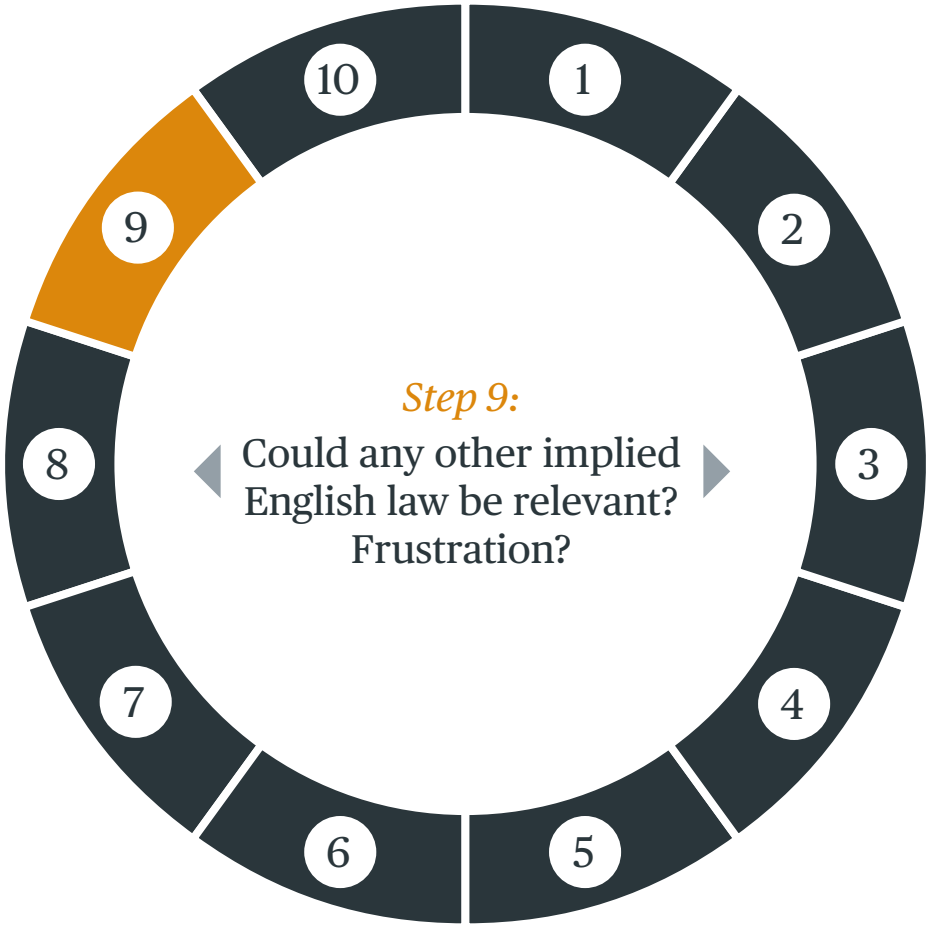

Step 9:

Could any other implied English law be relevant? Frustration?

English law recognises the common law doctrine of frustration. However, if a contract includes a force majeure clause, the common law rules on frustration are ordinarily displaced in relation to that same event[4] so that frustration cannot be relied on as an alternative.

This means that if a party has a legitimate claim for force majeure, but fails for example to invoke a contractual procedure under the relevant clause, it is very likely that it could not argue frustration in relation to the same event, because the frustration remedy has been inadvertently lost by not complying with the specific provisions of the contract.

If there is no force majeure clause, frustration may enable a party to avoid its contractual duties. However it will need to show:

1. the event was unexpected and beyond the control of the parties; and
2. the event renders it physically or legally impossible to fulfil the contract, or transforms the obligation to perform into a radically different obligation from that undertaken when the contracted was agreed.

[4] Jackson v United Maritime Insurance [1874] LR10 CP 125

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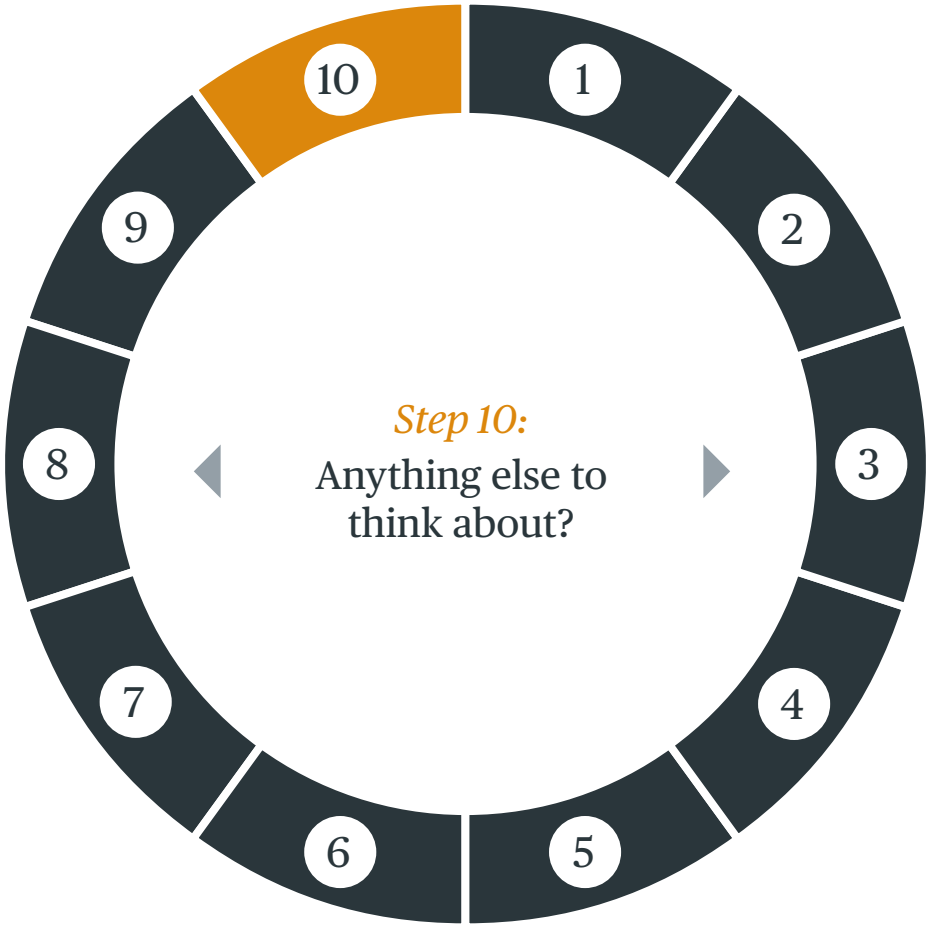

1. Follow the contractual process for notification meticulously.
2. Take a holistic view of the contract analysis - consider what clauses may help/hinder and don't forget to look at the boilerplate clauses.
3. Retain documented evidence of steps you are taking, the reasons surrounding those steps and steps taken to mitigate (and also steps counterparties may be taking if they are the ones invoking force majeure). This could include credible records – including trustworthy public domain information where available -which set out the factual context for the decision in question. It is important to document the alternative options available at the time of performance (or lack of them!).
4. Consider whether you wish to adopt a collaborative/non-adversarial approach to resolve the issue. Early engagement with contract counterparties and a collaborative resolution of issues may be preferable to an adversarial approach.
5. Re-source supply wholly or partially - risks can be reduced or removed if you have a viable alternative which can be implemented quickly. Consideration should be given to the lead times for re-supply and how these fit with existing inventory. Be careful as re-sourcing may be in breach of existing 'exclusive' supply contracts. Many utilisation-based supply or maintenance contracts confer exclusivity on the supplier.
6. Recover assets - you may have supplied equipment or certain assets may be used under licence from you. Equally, there may be stock or other materials on site which belong to you. The terms of any applicable contract will strongly influence your ability to recover these items.
7. Ensure you make all required third party notifications in a timely fashion (including insurance, industry regulators, etc.).

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