

Contracting in a crisis – it's good to talk

Greg Gibson examines whether the law would allow suppliers to use the credit crunch as an excuse for non-performance of the contract and what customers can do to avoid service providers in financial difficulties leaving them in the lurch.

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Recent developments in the financial markets and, in particular, the unavailability of bank finance have caused significant difficulties for a wide range of businesses. It would be unrealistic to think that the facilities management sector is immune from a downturn in the wider economy. The withdrawal of finance facilities, increases in the cost of finance and the failure of customers to pay on time (or underlying suppliers to perform) may cause significant problems for facilities management suppliers and customers alike.

This article looks at the effect that the economic downturn may have on customers' or suppliers' ability to perform their contractual obligations – and the extent to which they may use the economic downturn as an excuse for non-performance. The article also looks at the impact that the economic downturn may have on customers' outsourcing strategies and the way in which customers and suppliers may structure future deals.

THIS CREDIT CRUNCH – IT'S SO FRUSTRATING

A supplier which finds that the withdrawal of bank finance, or an increase in the cost of finance, renders the performance of its contractual obligations impossible – or commercially unsustainable – may be excused for thinking that the law would step in to protect it from claims for breach of contract. After all, the supplier will be suffering enough difficulty already, without having to defend complicated and expensive legal claims. In circumstances like this, suppliers often ask their lawyers why they cannot simply walk away: surely the law won't push a business to the brink – or even over it – just for the sake of a contract? However, English law does not allow contracting parties, once they have agreed a deal, to walk away that easily – even where changes in circumstances mean that the commercial rationale for the deal at the time of signature may no longer make sense.

English law does, however, allow contracting parties to treat a contract as "frustrated" if unforeseen circumstances render its performance either physically or commercially impossible. Frustration allows both parties to walk away from a contract without further liability.

The concept of physical impossibility is easy to understand. The classic example is the contract for the hire of a venue, where, between the time of signing the contract and the hire date, the venue is destroyed by fire. It is clear that it is physically impossible to fulfil the contract: the venue no longer exists. In these circumstances, the contract has been frustrated.

The concept of commercial impossibility is more difficult to grasp. To be frustrated, the contract has to have become commercially *impossible* to perform – not merely commercially inconvenient or commercially unattractive. As long ago as 1952, the House of Lords ruled that: "[A] turn of events which [the parties] did not at all anticipate – a wholly abnormal rise or fall in prices, a sudden depreciation of currency, an unexpected obstacle to execution, or the like ... does not in itself affect the bargain which they have made."

It is clear from this and other cases that English law holds the sanctity of a contract very dear: if a supplier has agreed to do something, the law expects the supplier to do it – even if it becomes commercially unattractive to do so.

BUT IT'S NOT MY FAULT

Suppliers may look to the *force majeure* clauses in their facilities management contracts and argue that macro-economic developments are beyond their reasonable control. Again, the approach of the courts to this is likely to be that changes in financial circumstances do not *prevent* a party from performing its obligations: they simply make performance more costly. This was illustrated perfectly in a 2005 case in which a gas supplier argued that a *force majeure* clause applied because it had become uneconomic for it to supply gas at the contracted price. The court did not accept this argument – the supplier could only be excused if it had been unable to perform: the fact that performance at the contracted price was uneconomic was irrelevant.

Courts are also likely to question whether the effects of macro-economic developments are really beyond a supplier's control: exchange-rate fluctuations can be hedged; contracts can be drafted to allow price variations in defined circumstances, and so forth.

FINANCIAL DISTRESS – LET'S TALK ABOUT IT

It is not possible to say that the doctrine of frustration or the concept of *force majeure* will *never* be triggered by macro-economic events (and, of course, unprecedented circumstances are just the excuse the courts need to set a new precedent). Nevertheless, it

is clear that suppliers would be unwise to enter into a facilities management contract hoping that they might be able to rely on frustration or *force majeure* if their financial situation deteriorates.

It would, however, make sense for parties negotiating facilities management contracts in the current climate to include provisions to enable both parties to monitor financial developments and the impact they may have on a supplier's ability to supply. This is particularly advisable in the case of contracts relating to business-critical services – such as information and communication technology (ICT) services, hospital cleaning or buildings management and security. A suitable starting point may be the Financial Distress Schedule (Sch. 7.4) to the Office of Government Commerce (OGC) standard ICT Services Agreement (available through the Partnerships UK website at www.partnershipsuk.org.uk).

The Financial Distress Schedule has not always found favour with suppliers or customers, partly because there is a natural resistance to providing financial information (which parties would traditionally treat as highly confidential) and partly because the issues and concepts involved (credit-rating agencies, breach of banking covenants and so forth) are the types of issue more frequently found in merger-and-acquisition and bank-finance agreements than facilities management contracts.

The basic principle of the Financial Distress Schedule is that there should be early warning and open discussion of financial difficulties in the supplier's business and how these may affect services. The Schedule requires certain steps to be taken when various "financial distress levels" are reached. These financial distress levels are triggered by events such as:

- the supplier's credit ratings dropping below a defined level;
- the supplier issuing a profits warning;
- the supplier committing breaches of its banking covenants; or
- the supplier failing to pay subcontractors.

At each financial distress level, the steps to be taken, or the consequences for the supplier, become more serious. They range from meeting with the customer for discussions, through implementing recovery plans and payment of the contract price into an escrow account for the benefit of subcontractors, to outright termination of the contract.

Even if the parties to a facilities management contract do not want to adopt the Financial Distress Schedule in the form in which it is presented by the OGC, the broad principles of early warning and escalation are good ones and should be welcomed by suppliers and customers alike. They offer a structure within which the parties can meet and share information in an honest and open way.

The benefits for the customer are clear: it may be possible to avoid significant business disruption. However, the benefits for the supplier should not be

overlooked: rather than running the risk of defaulting under the contract (with all the legal and publicity consequences that follow), it has an opportunity to discuss problems and possible solutions at an early stage and re-negotiate the scope of its obligations or liabilities to the benefit of not only the customer but also the supplier's own shareholders, staff and sub-contractors.

OUTSOURCING STRATEGY

Some customers may question whether facilities management outsourcing makes sense at all in the current climate. Is outsourcing a vital service to a company which may go bust worth the risk?

Although it is important to weigh up such risks, the current economic woes do not detract from the underlying logic of many facilities management outsourcing deals. However, we are likely to see different outsourcing strategies develop in light of the credit crunch. At one extreme, some customers may seek to spread risk through multi-sourcing. Although multi-sourcing does not necessarily deliver the efficiency benefits that a single-supplier outsourcing contract may bring, customers may consider that

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the additional cost is a price worth paying for security of supply.

Where we are more likely to see a change of approach is in the extent to which customers seek to maintain in-house expertise. In any outsourcing arrangement, there is always a debate about how much expertise should be outsourced and how much should be retained. The customer always needs to retain enough knowledge of the outsourced services to enable it to act as an "intelligent client".

However, in the current climate, effective governance and robust contract management become more important; and these require capable people with an in-depth knowledge of the services and an ability to take practical and commercial decisions in light of the financial and other management information provided by the supplier. This level of expertise will be vital if the customer has to bring the services back in-house or manage the transition to a new supplier should the worst happen.

A PROACTIVE APPROACH

As the ostrich found, burying your head in the sand is rarely the best course of action. Leaving things to the vagaries of frustration or *force majeure* is unlikely to be to anyone's benefit. Parties really should have open and frank discussions at the negotiation stage to agree clear financial distress arrangements, providing a clear structure to be followed as soon as financial concerns first arise.

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