

ARTICLE

# Ordinary Times in Extraordinary Circumstances

Analysis of legal implications and damages considerations in light of COVID-19

## A. INTRODUCTION<sup>1</sup>

On 11 March 2020, the World Health Organization (“WHO”), based on its assessment, characterised COVID-19 as a pandemic. Following the outbreak and the subsequent lockdown measures undertaken by the Government of India in March 2020, all industries have been impacted, albeit to varying degrees.

Industries such as retail, tourism, hospitality, aviation, railways, automobiles, etc., are expected to be most affected and will likely experience significant distress. Food and beverages, media and services companies are expected to be moderately impacted. Some sectors such as internet service and communication software companies might even witness growth.<sup>2</sup>

Supply chains that were dependent on just-in-time deliveries of parts or finished products to manage inventory levels are facing significant disruption due to unavailability of labour, raw material and restrictions on transportation.

*“We are placed today in uncomfortably peculiar circumstances. A pandemic, of the nature which affects the world today, has not visited us during the lifetime of any of us and, hopefully, would not visit us hereinafter either. The devastation, human, economic, social and political, that has resulted as a consequence thereof, is unprecedented. The measures, to which the executive administration has had to resort, to somehow contain the fury of the pandemic, are equally unprecedented.”*

*- Hon’ble Justice Mr. C. Hari Shankar, Hon’ble High Court of Delhi*

<sup>1</sup> This article is jointly written by Cyril Amarchand Mangaldas (“CAM”) and FTI Consulting (“FTI”). Specifically, Sections A, B and G are jointly written by CAM and FTI. Sections C to D and Sections E to F are written by CAM and FTI respectively. Please note that this article is updated as of 31 May 2020.

<sup>2</sup> <https://www.moodyanalytics.com/articles/2020/dual-risk-rating-and-origination-strategies>.

Against this background, performance of commercial contracts will likely become more difficult, with consequences for all parties involved. In this article, we will discuss potential contractual provisions and risk management strategies that may be available to businesses in managing any negative consequences arising from non-performance of their contractual obligations. We will then discuss the implications of the current crisis on quantification of damages in commercial disputes arising out of or during the pandemic.<sup>3</sup>

The article is structured as follows:

- (1) First, we will provide a brief overview of the current state of affairs. In doing so, we will summarise the economic impact of COVID-19 and the legal and regulatory developments that have followed since the virus was declared a pandemic;
- (2) Second, we will introduce and discuss the legal concepts of *force majeure* and frustration of a contract, and the implications of such events on performance of contracts. We will do so by using a hypothetical example of a potential dispute between a seller and a buyer, arising from the seller's alleged wrongful termination of contract, involving sale and purchase of refrigerators and air-conditioning products between the seller and the buyer; and
- (3) Third, we will briefly discuss the overall framework for calculating damages and the implications of the economic and financial consequences of the pandemic on calculation of damages.



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<sup>3</sup> This article focuses on the commercial, legal and economic consequences. That is not to at all downplay or overlook, in the very first instance, the pandemic's human, health and social costs which are significant and sad.

## B. BRIEF OVERVIEW OF THE CURRENT SITUATION

### Economic impact of COVID-19

The impact of COVID-19 has been large and widespread. Countries are taking unprecedented measures to contain the spread of the deadly virus and have restricted domestic and international travel, implemented strict social distancing measures and significantly curtailed economic and business activities.

This has affected almost all aspects of commercial transactions and has disrupted supply and distribution chains across the globe, affected international trade and altered production and consumption patterns. For example, the World Trade Organization (“WTO”) expects global merchandise trade to decline by between 13 percent and 32 percent in 2020.<sup>4</sup> Further, the International Monetary Fund (“IMF”) has projected the global economy – as measured by the real gross domestic product (“GDP”) – to contract by almost 3 percent in 2020.<sup>5</sup> This compares to the earlier projected growth of 3 percent as on at 9 January 2020.<sup>6</sup>



The above developments, in turn, have resulted in stock market declines and volatility eroding trillions of dollars in wealth – as investors react to short and medium-term implications of the pandemic. As the figure shows, global stock market indices fell by an average of ~20 percent<sup>7</sup> between 1 January 2020 and 31 March 2020.

<sup>4</sup> [https://www.wto.org/english/news\\_e/pres20\\_e/pr855\\_e.htm](https://www.wto.org/english/news_e/pres20_e/pr855_e.htm), and [https://www.wto.org/english/news\\_e/news19\\_e/anrp\\_04jun19\\_e.htm](https://www.wto.org/english/news_e/news19_e/anrp_04jun19_e.htm).

<sup>5</sup> <https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>.

<sup>6</sup> <https://www.imf.org/en/Publications/WEO/Issues/2020/01/20/weo-update-january2020>.

<sup>7</sup> Decrease in MSCI World Index which is composed of 1500 constituents listed on stock exchanges of various developed markets.

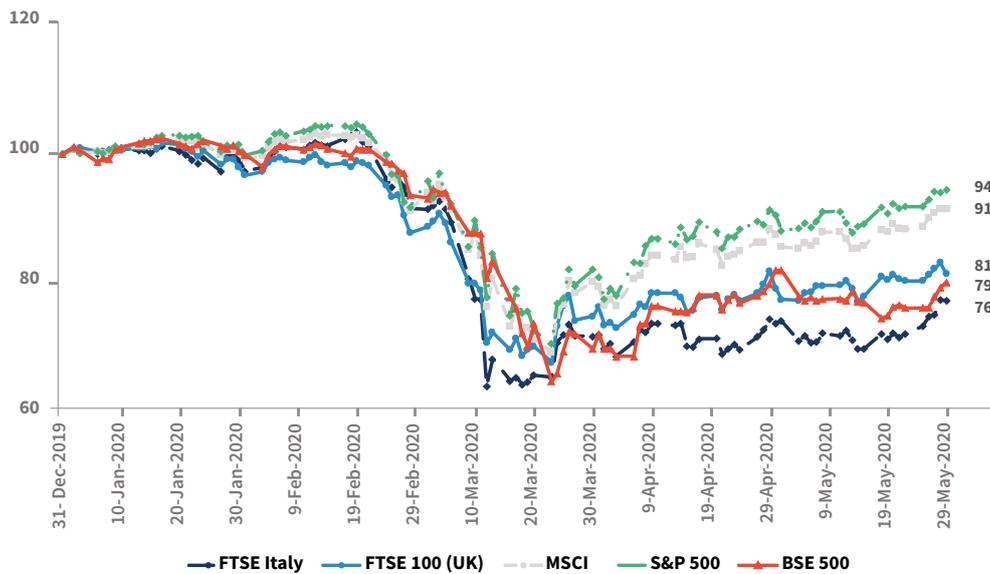


Figure 1: Impact of COVID-19 on global stock markets<sup>8</sup>

India is not immune to the negative developments. At the start of the year 2020, IMF projected India's real GDP to grow at 5.8 percent in FY2021.<sup>9</sup> In April 2020, IMF revised its growth projections down to 1.9 percent. As per the current estimates produced in May 2020, many organisations now expect the Indian economy to contract by up to 5 percent in FY2021.<sup>10</sup> As the figure above shows, the BSE 500 index's performance has largely mirrored the other global indices and has declined about 20 percent since the start of 2020.<sup>11</sup> Currency exchange rates and government bond yields have also been impacted. The Indian Rupee ("INR") has weakened considerably against the US dollar ("USD"), with USD-INR exchange rate increasing from INR 71.2 per USD on 31 December 2019 to INR 75.5 per USD on 31 May 2020. Similarly, interest rates on 10-year bonds issued by the Indian government declined from 6.5 percent on 1 January 2020 to 6.0 percent on 29 May 2020.<sup>12</sup> National lockdown has further impacted the economy, with almost 50 million jobs lost in April 2020.<sup>13</sup>

### Legal and regulatory developments in India on account of COVID-19

In India, approximately 700 major notifications have been passed by the Central Government,<sup>14</sup> and around 4,000 notifications by the various State Governments<sup>15</sup> to *inter alia* control the spread of the COVID-19 outbreak. The preventive actions taken by India, albeit necessary, have affected most commercial transactions, leaving parties to face challenges in performance of their contractual obligations. The Indian Government imposed a lockdown in the country on 25 March 2020, which continues to be in effect till 30 June 2020 for containment zones.<sup>16</sup>

Among the several notifications passed by the Central Government of India, we have listed below a few such notifications issued till 17 May 2020 that may have affected performance of contracts:

- (i) Ban on operations of non-essential e-commerce companies;<sup>17</sup>
- (ii) Prohibition on export of all personal protection equipment, including clothing and masks [coveralls (Class

<sup>8</sup> Source: S&P Capital IQ, Market levels as of 31 December 2019 have been indexed to 100. Market data as of 31 May 2020.

<sup>9</sup> <https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>. Financial year running from April to March.

<sup>10</sup> <https://www.bloomberquint.com/economy-finance/indias-gdp-growth-likely-to-contract-52-in-fy21-says-nomura>;

<https://economictimes.indiatimes.com/news/economy/indicators/indias-economy-to-contract-by-3-2-per-cent-in-fiscal-year-2020-21-world-bank/articleshow/76266999.cms>;

<https://www.livemint.com/news/india/fitch-joins-the-bandwagon-sees-india-gdp-contract-5-in-fy21-11590518605611.html>;

<https://www.newindianexpress.com/business/2020/may/22/indian-economy-to-contract-in-fy21-lockdown-compounds-economic-challenges-says-moodys-2146625.html>;

<https://www.nationalheraldindia.com/business/economy-likely-to-contract-by-5-in-fy21-icra>;

[https://www.business-standard.com/article/economy-policy/goldman-sachs-nomura-lower-fy21-gdp-estimate-for-india-see-more-rate-cuts-120050800738\\_1.html](https://www.business-standard.com/article/economy-policy/goldman-sachs-nomura-lower-fy21-gdp-estimate-for-india-see-more-rate-cuts-120050800738_1.html).

<sup>11</sup> S&P Capital IQ.

<sup>12</sup> Thomson Reuters Eikon and S&P Capital IQ.

<sup>13</sup> <https://economictimes.indiatimes.com/news/economy/indicators/unemployment-rate-dips-to-23-97-data-from-cmie-shows/articleshow/75689370.cms?from=mdr>.

<sup>14</sup> <https://prsindia.org/covid-19/notifications>.

<sup>15</sup> Ibid.

<sup>16</sup> [https://prsindia.org/files/covid19/notifications/IND\\_Lockdown\\_Extension\\_June30\\_31052020.pdf](https://prsindia.org/files/covid19/notifications/IND_Lockdown_Extension_June30_31052020.pdf).

<sup>17</sup> Though allowed for the short interval on 15 and 16 April 2020, was banned later, on 19 April 2020; [https://prsindia.org/files/covid19/notifications/3132.IND\\_Exemption\\_Lockdown\\_April\\_19.pdf](https://prsindia.org/files/covid19/notifications/3132.IND_Exemption_Lockdown_April_19.pdf).

2/3/4) and N-95 masks];<sup>18</sup> ventilators, surgical/disposable masks (2/3 ply masks), sanitisers and textile raw material used for making masks and coveralls.<sup>19</sup> This was amended by way of a notification dated 16 May 2020 to prohibit the export of all masks except non-surgical/non-medical masks of all types;<sup>20</sup>

(iii) Closing of all educational establishments, gyms, museums, cultural and social centres, swimming pools and theatres;

(iv) Advisory on minimising meetings involving large numbers of people unless necessary;

(v) Advisory to all sports organisations and their affiliate units to not hold any sports events, including competitions or selection trials;<sup>21</sup>

(vi) Prohibition on landing of any international commercial passenger aircraft until 31 May 2020; and banning of all scheduled domestic flights (except all-cargo flights) and flights by holders of non-scheduled operator permit (except all-cargo flights, off-shore helicopter operations, medical evacuation flights, or flights especially approved by Directorate General of Civil Aviation);<sup>22</sup>

(vii) Enhancement of production of hand sanitisers and availability of ethyl alcohol/extra neutral alcohol<sup>23</sup> and regulation of production, quality, distribution, prices and other aspects of alcohols used in manufacturing hand sanitisers (including all the raw materials involved);<sup>24</sup>

(viii) Suspension of passenger trains (other than the Special Shramik Trains);<sup>25</sup>

(ix) Restarting manufacturing industries after the lockdown period (of 17 May 2020);<sup>26</sup>

(x) Declaration of power generation and electrical power transmission as an essential service;<sup>27</sup>

(xi) Allowing of inter-state movement of cargo/goods for inland and export;<sup>28</sup> and

(xii) Parties to a public-private partnership concession contract, may invoke *force majeure* for all construction/works contracts, goods and services contracts and public-private partnership contracts with Government agencies.<sup>29</sup>

Between 17 May 2020 and 31 May 2020, the following activities were permitted, including:<sup>30</sup>

(i) Inter and intra-state movement of passenger vehicles and buses with mutual consent of the State(s) and Union Territories(s) involved; and

(ii) Movement of individuals was permitted between 7 am to 7 pm.

During the said time, the country was designated in specific zones, based on risk profiling, into containment, buffer, red (hotspot), green and orange zones.<sup>31</sup> This order imposed complete restriction on all domestic and international air travel except for medical purposes, schools, colleges, hotels, restaurants (except for food delivery), cinema halls and religious places etc. Further, on 20 May 2020, domestic passenger air travel was removed from the list of prohibited activities,<sup>32</sup> and guidelines for such travel were issued. Train services were also ordered to resume from 1 June 2020.<sup>33</sup>

By an order dated 30 May 2020, the lockdown was extended in containment zones till 30 June 2020, and activities prohibited earlier, were to re-open in a phased manner.<sup>34</sup> Notably, while the Central Government of India has provided the consolidated guidelines, the State Governments can impose stricter measures to enforce it, however the same shall not be diluted by the State Governments.<sup>35</sup>

<sup>18</sup> [https://prsindia.org/files/covid19/notifications/15.Noti%2048%20PPE\\_0.pdf](https://prsindia.org/files/covid19/notifications/15.Noti%2048%20PPE_0.pdf).

<sup>19</sup> [https://prsindia.org/files/covid19/notifications/93.218857%20\(1\).pdf](https://prsindia.org/files/covid19/notifications/93.218857%20(1).pdf); [https://prsindia.org/files/covid19/notifications/140.Noti%2053\\_0.pdf](https://prsindia.org/files/covid19/notifications/140.Noti%2053_0.pdf).

<sup>20</sup> [https://prsindia.org/files/covid19/notifications/5780.IND\\_Export\\_Ban\\_Masks\\_May\\_16.pdf](https://prsindia.org/files/covid19/notifications/5780.IND_Export_Ban_Masks_May_16.pdf).

<sup>21</sup> [https://prsindia.org/files/covid19/notifications/1698.IND\\_sports\\_March19.pdf](https://prsindia.org/files/covid19/notifications/1698.IND_sports_March19.pdf); [https://prsindia.org/files/covid19/notifications/2732.IND\\_Revised\\_Consolidated\\_Guidelines\\_April\\_15.pdf](https://prsindia.org/files/covid19/notifications/2732.IND_Revised_Consolidated_Guidelines_April_15.pdf).

<sup>22</sup> [https://prsindia.org/files/covid19/notifications/4420.IND\\_DGCA\\_passenger%20air%20travel%20ban%20Extension\\_May\\_02.pdf](https://prsindia.org/files/covid19/notifications/4420.IND_DGCA_passenger%20air%20travel%20ban%20Extension_May_02.pdf); [https://prsindia.org/files/covid19/notifications/2778.IND\\_DGCA\\_Circular%20Domestic%20Extension\\_Apr\\_14.pdf](https://prsindia.org/files/covid19/notifications/2778.IND_DGCA_Circular%20Domestic%20Extension_Apr_14.pdf); [https://prsindia.org/files/covid19/notifications/5771.IND\\_DGCA\\_passenger%20air%20travel%20ban%20Extension\\_May\\_17.pdf](https://prsindia.org/files/covid19/notifications/5771.IND_DGCA_passenger%20air%20travel%20ban%20Extension_May_17.pdf).

<sup>23</sup> [https://prsindia.org/files/covid19/notifications/99.IND\\_DFPD%20Letter%20to%20States%20to%20Permit%20Alcohol%20and%20Distilleries\\_March%2019.pdf](https://prsindia.org/files/covid19/notifications/99.IND_DFPD%20Letter%20to%20States%20to%20Permit%20Alcohol%20and%20Distilleries_March%2019.pdf).

<sup>24</sup> [https://prsindia.org/files/covid19/notifications/98.IND\\_DCA%20Alcohols%20for%20Hand%20Sanitizers%20as%20ECs%20Price%20Cap\\_March%2019.pdf](https://prsindia.org/files/covid19/notifications/98.IND_DCA%20Alcohols%20for%20Hand%20Sanitizers%20as%20ECs%20Price%20Cap_March%2019.pdf); [https://prsindia.org/files/covid19/notifications/4825.IND\\_Export\\_Alcohol\\_Based\\_Hand\\_Sanitizers\\_Prohibited\\_May\\_6.pdf](https://prsindia.org/files/covid19/notifications/4825.IND_Export_Alcohol_Based_Hand_Sanitizers_Prohibited_May_6.pdf).

<sup>25</sup> [https://prsindia.org/files/covid19/notifications/2769.IND\\_Rail\\_Passenger\\_Cancellation\\_Extended\\_Apr\\_14.pdf](https://prsindia.org/files/covid19/notifications/2769.IND_Rail_Passenger_Cancellation_Extended_Apr_14.pdf).

<sup>26</sup> [https://prsindia.org/files/covid19/notifications/IND\\_NDMA\\_Guidelines\\_Restarting\\_Manufacturing\\_May\\_9.pdf](https://prsindia.org/files/covid19/notifications/IND_NDMA_Guidelines_Restarting_Manufacturing_May_9.pdf).

<sup>27</sup> [https://prsindia.org/files/covid19/notifications/168.IND\\_Operation\\_RE\\_Gen\\_Utillies\\_Mar\\_26.pdf](https://prsindia.org/files/covid19/notifications/168.IND_Operation_RE_Gen_Utillies_Mar_26.pdf); [https://prsindia.org/files/covid19/notifications/156.IND\\_Operation\\_Elec\\_Transmission\\_Network\\_Mar\\_25.pdf](https://prsindia.org/files/covid19/notifications/156.IND_Operation_Elec_Transmission_Network_Mar_25.pdf).

<sup>28</sup> [https://prsindia.org/files/covid19/notifications/158.IND\\_Citizens\\_Guidelines\\_LockdownAddendum\\_Mar\\_24.pdf](https://prsindia.org/files/covid19/notifications/158.IND_Citizens_Guidelines_LockdownAddendum_Mar_24.pdf).

<sup>29</sup> [https://prsindia.org/files/covid19/notifications/5642.IND\\_DoE%20Contract%20Extension%20FMC\\_May%2013.pdf](https://prsindia.org/files/covid19/notifications/5642.IND_DoE%20Contract%20Extension%20FMC_May%2013.pdf). It is to be noted that invocation of *force majeure* clause here would absolve all non-performance of a party to the contract, as long as such non-performance is attributable to a lockdown situation or restrictions imposed under any act or executive order on account of the COVID-19 global pandemic.

<sup>30</sup> [https://prsindia.org/files/covid19/notifications/IND\\_MHA\\_Lockdown\\_Extension\\_upto\\_May31\\_17052020.pdf](https://prsindia.org/files/covid19/notifications/IND_MHA_Lockdown_Extension_upto_May31_17052020.pdf).

<sup>31</sup> [https://prsindia.org/files/covid19/notifications/IND\\_MHA\\_Lockdown\\_Extension\\_upto\\_May31\\_17052020.pdf](https://prsindia.org/files/covid19/notifications/IND_MHA_Lockdown_Extension_upto_May31_17052020.pdf).

<sup>32</sup> [https://prsindia.org/files/covid19/notifications/5885.IND\\_Lockdown\\_Domestic\\_Flight\\_Exemption\\_May\\_20.pdf](https://prsindia.org/files/covid19/notifications/5885.IND_Lockdown_Domestic_Flight_Exemption_May_20.pdf).

<sup>33</sup> [https://prsindia.org/files/covid19/notifications/5890.IND\\_Rail\\_guidelines%20for%20trains%20starting%20June%201\\_May\\_20.pdf](https://prsindia.org/files/covid19/notifications/5890.IND_Rail_guidelines%20for%20trains%20starting%20June%201_May_20.pdf).

<sup>34</sup> [https://prsindia.org/files/covid19/notifications/IND\\_Lockdown\\_Extension\\_June30\\_31052020.pdf](https://prsindia.org/files/covid19/notifications/IND_Lockdown_Extension_June30_31052020.pdf).

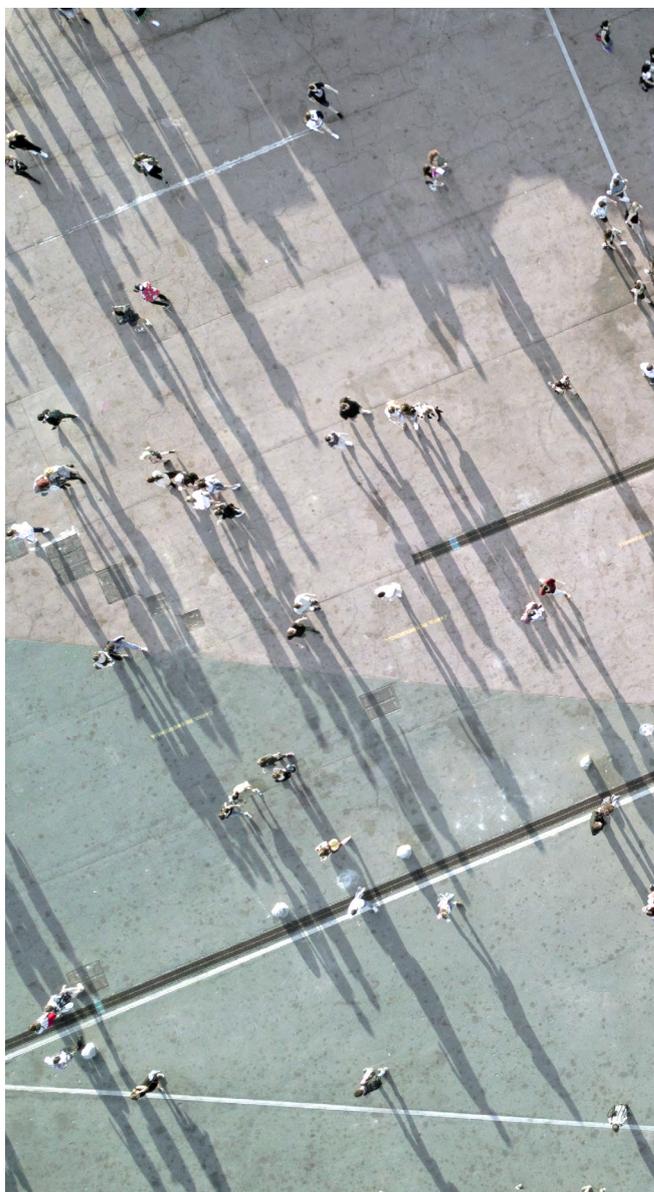
<sup>35</sup> [https://prsindia.org/files/covid19/notifications/3156.IND\\_States\\_Comply\\_April\\_19.pdf](https://prsindia.org/files/covid19/notifications/3156.IND_States_Comply_April_19.pdf).

### C. RISK MITIGATION STRATEGIES AND PERFORMANCE OF CONTRACTS

We believe that due to legal and regulatory developments in the times of COVID-19 and the impact on the world's economy, parties to a contract may fail in performing their contractual obligations, which may result in disputes between the parties. In order to understand the impact of COVID-19 on the performance of contractual obligations by the parties to a contract, unique contractual provisions of each such contract would be required to be analysed. We explain these contractual provisions as per Indian law in the sub-section below.

In this article, we have sought to explain the general concepts of a contract likely relevant in the current times, by way of a hypothetical example. Our example involves a seller ("Seller") and a buyer ("Buyer") wherein the Seller and the Buyer have entered into a contract for the sale and purchase of refrigerators and air-conditioning products ("Goods"). We assume that the contract is valid for a period of three years from the date of its execution (January 2019). The Goods are to be delivered in the quantities mentioned in the contract, at the specified delivery location, date and time. The contract also provides for the Seller to deliver goods to the Buyer on the last day of every month. The Seller is obligated under the contract to notify the Buyer immediately if the Seller is not able to complete its contractual obligations in time. Delay in sale and delivery of the Goods by the Seller gives the Buyer the right to terminate the contract. The contract also contains a *force majeure* clause, which states:

*"A force majeure shall mean any extraordinary event or circumstance beyond human control such as an event described as an act of God (like a natural calamity) or events such as a war, strike, riots, crimes (but not including negligence or wrong-doing, predictable/seasonal rain and any other events specifically excluded in the clause). An force majeure event/circumstance in the contract frees both parties from contractual liability or any obligation when prevented by such event from fulfilling their obligations under the contract. However, this shall not excuse a party's non-performance entirely, but only shall suspend it during such an event. The supplier has to give notice of force majeure as soon as it occurs, and it cannot be claimed ex-post facto." ("Force Majeure Clause")*



Due to the COVID-19 lockdown, we assume that the Seller has failed to perform his obligations under the contract in February 2020 and March 2020. Consequently, the Seller, after expiry of 30 (Thirty) days, terminates the contract at the end of March 2020 on the following grounds:

- (i) The import of parts for the manufacture of the Goods (refrigerators and air conditioning products) from China has been impacted due to the spread of COVID-19 and the Seller has been unable to manufacture the Goods for sale;
- (ii) The contract became impossible to perform due to non-availability of parts required for the manufacture of the Goods; and
- (iii) The Seller is not liable to pay any damages for the failure to deliver the Goods because of the applicability of the *force majeure* Clause as per the contract between the Buyer and the Seller.

The Buyer aggrieved by the termination of the contract, invokes arbitration against the Seller in April 2020, seeking damages for wrongful termination of the contract and takes the following defense:

- (i) Delay because of COVID-19 cannot be covered under the *Force Majeure* Clause, and therefore the Seller cannot be excused from performing its obligations;
- (ii) The contract cannot stand frustrated because neither import of parts from China for manufacture of the Goods was banned by India, nor the export of such parts from China was banned by China;
- (iii) The Seller is liable to specifically perform its obligations under the contract; and
- (iv) Arguendo, even if the Seller's failure to perform its obligations is assumed to be protected under the *Force Majeure* Clause, the Seller ought to have notified the Buyer of the same immediately upon occurrence of the *force majeure* event.

We now analyse the legal concepts of *force majeure*, doctrine of frustration and how these might apply to the above dispute between the Buyer and the Seller.

### **Indian law on *force majeure* clauses and doctrine of frustration of a contract**

The expression *force majeure* is a French version of the Latin expression *vis major*, meaning an 'act of God'. A reference to *force majeure* shows parties' intention to save the performing party from the consequences of anything over which it has no control.<sup>36</sup> However, it is relevant to

understand that the question of applicability of a *force majeure* clause and its ambit shall primarily depend on unique contractual provisions and the evidence brought forward by the parties during the course of their dealings. A *force majeure* clause may contain events such as an act of God, governmental action, pandemic, extraordinary circumstances that are beyond human control, war, riot, etc. Such a clause merely suspends the obligations of the parties for the duration of the event/situation that was envisaged in such a clause and does not excuse any party from performing its contractual obligations. Notwithstanding the above, a contract may or may not contain a *force majeure* clause.

For a party to take the benefit of a *force majeure* clause, such a clause ought to envisage an extraordinary event that is beyond human control. Albeit such clauses are generally broadly worded, the Supreme Court of India has held that the same should be narrowly construed and importance be given to the terms of the contract.<sup>37</sup> Further, in so far as the impossibility to perform contractual obligations is concerned, due to the occurrence of a *force majeure* event, it shall be governed by Section 32 of the Indian Contract Act, 1872 ("ICA"), which would render the contract void, in such a situation.

It is possible that a contract, due to COVID-19, may merely be suspended or there may be delay/interference in its performance, and parties may not be relieved of their contractual obligations merely because COVID-19 has become a world pandemic. However, to ascertain the effects of COVID-19 on a contract, primary importance ought to be given to distinctive terms and conditions of a contract.

Usually when a contract contains a *force majeure* clause, which covers a situation/event that has occurred, it will preclude the application of Section 56 of the ICA.<sup>38</sup> Although, such a clause may not exhaustively set out the possibility of unforeseen events occurring outside natural and/or unnatural events. This might mean that if the parties were not able to foresee the situation/event that has actually occurred, the contract could stand frustrated under Section 56 of the ICA. This should, however, not be confused with the fact that when consequences of the situation/event envisaged under the contract are specifically provided for in a contract, the parties will be bound by such a clause and cannot take the defense under Section 56 of the ICA. This has been clarified by the Supreme Court of India:

<sup>36</sup> Dhanrajamal Gobindram v. Shamji Kalidas & Co., AIR 1961 SC 1285, 91.

<sup>37</sup> Energy Watchdog v. Central Electricity Regulatory Commission, [2017] 14 SCC 80 [39].

<sup>38</sup> Energy Watchdog v. Central Electricity Regulatory Commission, [2017] 14 SCC 80 [39].

*“[I]f the parties do contemplate the possibility of an intervening circumstance, which might affect the performance of the contract, but expressly stipulates that the contract would stand despite such circumstance, there can be no case of frustration because the basis of the contract being to demand performance despite the happening of a particular event, it cannot disappear when that event happens.”<sup>39</sup>*

Section 56 of the ICA incorporates the doctrine of frustration of a contract. In *Satyabrata Ghose v. Mugneeram Bangur and Co.*,<sup>40</sup> Mukherjee J. explained that Section 56 discharges the obligation to perform because of inherent impossibility attached to it.<sup>41</sup> However, it also envisages an agreement to do an act, which becomes impossible or unlawful and is therefore void. Mukherjee J. stated:

*“[T]he word “impossible” has not been used in the sense of physical or literal impossibility. The performance of an act may not be literally impossible, but it may be impracticable and useless from the point of view of the object and purpose which the parties had in view. Therefore, if an untoward event or change of circumstances totally upsets the very foundation upon which the parties rested their bargain, it can very well be said that the promisor finds it impossible to do the act which he promised to do.”<sup>42</sup>*

For a contract to be frustrated under Section 56 of the ICA, three tests have been laid down, i.e. (1) there must be a subsisting contract, (2) some part of the contract is still to be performed and (3) performance has become impossible after the contract was entered into.<sup>43</sup> The Supreme

Court of India has in the year 2017 opined on certain additional factors to the above-mentioned list through a “multifactorial” approach as stated below:

*“[T]he application of the doctrine of frustration requires a multi-factorial approach. Among the factors which have to be considered are the terms of the contract itself, its matrix or context, the parties’ knowledge, expectations, assumptions and contemplations, in particular as to risk, as at the time of the contract, at any rate so far as these can be ascribed mutually and objectively, and then the nature of the supervening event, and the parties’ reasonable and objectively ascertainable calculations as to the possibilities of future performance in the new circumstances.”<sup>44</sup>*

Therefore, the intention of the parties at the time of entering into the contract, which may not be directly ascertainable from the terms of a contract, is also a relevant factor to ascertain whether the doctrine of frustration shall apply to the case.

In every situation, it must be noted, that the intention of the parties, proved through evidence adduced by them, is of primal importance, and application of Section 56 of the ICA would depend on the same. Further, it has also been held that applying the doctrine of frustration must always be within narrow limits.<sup>45</sup> If Section 56 of the ICA is held to be applicable to a particular case, the principle of restitution under section 65 of the ICA shall thereafter apply and the consideration received under the contract by a party must be repaid. However, one must note that the doctrine of frustration and doctrine of impossibility, shall not apply merely because the performance of a contract has become burdensome or onerous or uneconomical for parties, and when the foundation of the contract is not substantially damaged.

<sup>39</sup> *Delhi Development Authority v. Kenneth Builders and Developers Ltd*, AIR 2016 SC 3026 [33].

<sup>40</sup> AIR 1954 SC 44.

<sup>41</sup> *Satyabrata Ghose v. Mugneeram Bangur and Co.*, AIR 1954 SC 44.

<sup>42</sup> *Satyabrata Ghose v. Mugneeram Bangur and Co.*, AIR 1954 SC 44.

<sup>43</sup> *Industrial Finance Corporation of India Ltd v. The Cannanore Spinning and Weaving Mills Ltd*, AIR 2002 SC 1841 [43]; *Sharda Mahajan v. Maple Leaf Trading International Pvt Ltd*, [2007] 139CompCas 718 [29].

<sup>44</sup> *Energy Watchdog v. Central Electricity Regulatory Commission*, [2017] 14 SCC 80 [39].

<sup>45</sup> *Satyabrata Ghose v. Mugneeram Bangur and Co.*, AIR 1954 SC 44.

## Impact of prohibitions by the Government on performance of a contract

Parties to a contract may find that performance is rendered impossible by the intervention of governmental action, even though, but for such action the contract was (in spite of say COVID-19) capable of being performed. For example, several States and Union Territory Governments such as Maharashtra,<sup>46</sup> Delhi,<sup>47</sup> etc., have issued advisories relating to COVID-19 to stop all operations of commercial establishments, factories, workshops, offices, go-downs, etc.

In such cases, however, it is necessary to distinguish cases of prohibition where the prohibition makes it unlawful for a party to the contract to fulfil its obligation, and where the prohibition does not make it unlawful, but destroys the benefit, which the performing-party to the contract was expecting to receive in lieu of the consideration to the contract.<sup>48</sup> In an appeal against a judgment and order of the High Court of Calcutta, rejecting an application for setting aside an award, the Supreme Court of India dealt with the question – *“was there a change in the policy of the Government of India of a total prohibition of import of Pakistan jute as contended by the appellants which was not foreseen by the parties and which intervened at the time of performance and which made the performance of their stipulation to obtain a licence impossible?”*

The Apex Court on scrutinising the relevant policy found that the government had not placed a total embargo on import of jute from Pakistan, but had only put certain qualifications in order to procure an import licence.<sup>49</sup> Moreover, the contract between the parties in this case contemplated a situation for delay, owing to non-furnishing of import licence and also provided for consequences of the same. Also, the Appellant was unable to get a licence, due to failure in meeting the qualifications provided by the government, and not because procuring of a licence became impossible. In view of the facts and circumstances, the Apex Court held that *“because of the said reasons, the question of importing an implied term into the contract would also not arise.”*<sup>50</sup> Further, the Court also held that:

*“...A contract is not frustrated merely because the circumstances in which it was made are altered. The Courts have no general power to absolve a party from the performance of his part of the contract merely because its performance has become onerous on account of an unforeseen turn of events.*

*In such a case, the doctrine of discharge by frustration cannot be available, nor that of an implied term that the existing state of affairs would continue at the date of performance. The reason is that where there is an express term, the court cannot find on construction of the contract an implied term inconsistent with such express term.”*

Therefore, it will be pertinent to review a *force majeure* clause to ascertain whether a party’s failure to perform its contractual obligations could be the result of a *force majeure* event on account of prohibition imposed by the Government.

The Delhi High Court<sup>51</sup> in its judgment dated 20 April 2020, by which the Court considered a Section 9 application under the Arbitration and Conciliation Act, 1996, for restraining invocation of bank guarantees by the Respondent No. 1, granted an interim relief to the Petitioner and held that the countrywide lockdown due to COVID-19, *prima facie* was in the nature of *force majeure*. Such a lockdown is unprecedented and was incapable of having been predicted either by Respondent No. 1 or by the Petitioner. The Court upon granting such an injunction, held that special equities existed in favour of the Petitioner. However, it is relevant to note that the Court vacated the said order on May 29, 2020 and held that *“the past non-performance of the Contractor cannot be condoned due to the COVID-19 lockdown in March 2020 in India. The Contractor was in breach since September 2019. Opportunities were given to the Contractor to cure the same repeatedly. Despite the same, the Contractor could not complete the Project. The outbreak of a pandemic cannot be used as an excuse for non-performance of a contract for which the deadlines were much before the outbreak itself.”*

<sup>46</sup> [https://prsindia.org/files/covid19/notifications/760.MH\\_Lockdown\\_Order\\_Mar\\_23.pdf](https://prsindia.org/files/covid19/notifications/760.MH_Lockdown_Order_Mar_23.pdf).

<sup>47</sup> [https://prsindia.org/files/covid19/notifications/228.DL\\_Lockdown\\_Order\\_Mar%2022.pdf](https://prsindia.org/files/covid19/notifications/228.DL_Lockdown_Order_Mar%2022.pdf).

<sup>48</sup> ‘Paxton Blair’, Breach of Contract due to War’ Colum. L. Rev. 20 (1920), 413.

<sup>49</sup> *Naihati Jute Mills Ltd. v. Khyaliram Jagannath*, (1968) 1 SCR 821.

<sup>50</sup> *Naihati Jute Mills Ltd. v. Khyaliram Jagannath*, (1968) 1 SCR 821.

<sup>51</sup> *Halliburton Offshore Services Inc v. Vedanta Limited & Anr.*, O.M.P (I) (Comm) & I.A. 3697 of 2020, dated April 20, 2020, however the said order was vacated by the order dated May 29, 2019.

## D. LEGAL IMPLICATIONS OF COVID-19 ON DISPUTE BETWEEN THE BUYER AND THE SELLER

In view of the above laid down legal position in India, we have analysed the legal implications of COVID-19 through our hypothetical example above. The legal implications can mainly fall under two scenarios: (i) Applicability of *Force Majeure* Clause; (ii) Inapplicability of *Force Majeure* Clause, resulting in mere termination of the contract due to the Seller's breach of contract arising out of COVID-19.



### Applicability of *Force Majeure* Clause

(i) The spread of COVID-19 may be covered under any *extraordinary event or circumstance beyond human control, such as an event described as an act of God*, as mentioned in the *Force Majeure* Clause (Please see part C of this article). This would lead to suspension of obligations of both the Seller and the Buyer during the subsistence/ outbreak of the virus. However, since the *Force Majeure* Clause here provides for service of immediate notice of the occurrence of such an event, the Seller not having provided such a notice, may not be allowed to take the benefit of the *Force Majeure* Clause.

(ii) Further, it may be relevant to keep in mind that the Ministry of Finance, Department of Expenditure Procurement Policy Division, have issued several notifications declaring inter alia disruption in supply food chain, due to the spread of COVID-19 in China or any other country, would be covered under the *force majeure* clause of the Manual of Procurement of the Goods, 2017, as it would constitute an extra ordinary event or circumstance beyond human control, however the same shall only be applicable in cases wherein non-performance of contract shall be attributable to the lockdown situation prevailing in the country.<sup>52</sup> Further, said notifications also recognise the restrictions placed on the movement of goods, services and manpower on account of the lockdown which may be making it impossible to perform

<sup>52</sup> [https://prsindia.org/files/covid19/notifications/5595.IND\\_DoE%20Performance%20Security%20Contracts%20FMC\\_May%202013.pdf](https://prsindia.org/files/covid19/notifications/5595.IND_DoE%20Performance%20Security%20Contracts%20FMC_May%202013.pdf);  
[https://prsindia.org/files/covid19/notifications/5642.IND\\_DoE%20Contract%20Extension%20FMC\\_May%202013.pdf](https://prsindia.org/files/covid19/notifications/5642.IND_DoE%20Contract%20Extension%20FMC_May%202013.pdf);  
[https://prsindia.org/files/covid19/notifications/108.IND\\_Time\\_Extension\\_Commissioning\\_RE\\_Projects\\_Mar\\_20.pdf](https://prsindia.org/files/covid19/notifications/108.IND_Time_Extension_Commissioning_RE_Projects_Mar_20.pdf).

contractual obligations. However, the said notifications are contract specific and may only have persuasive value on other contracts. It may also have to pass the test of judicial scrutiny on whether the spread of COVID-19 will be considered an extraordinary event, beyond human control.

(iii) In the event, it is adjudicated that the present case is covered under the *Force Majeure* Clause, the Buyer may not be able to claim any damages for claims such as loss of profits, etc.

#### **Inapplicability of Force Majeure Clause**

(i) In the event the spread of COVID-19 is not considered an extraordinary circumstance beyond human control, the Force Majeure Clause may not apply. It also may not apply if due process as mentioned under the Force Majeure Clause is not followed. In view of the same, the following may be relevant to consider for ascertaining the veracity of the Seller's defense:

(a) If the import of parts from China required for manufacture of the Goods was not banned by India, and the performance of the contract could be said to be unlawful or illegal;

(b) If the intention of the Seller and the Buyer in the contract shows that the delay in the delivery of the Goods could be cured, or if there is a provision for renegotiation on account of delay. This is because the intention of the parties to a contract is to be given primal importance, and if such a provision for delay has been canvassed by the parties, non-performance of Seller's obligations under the contract for the period of February-March 2020 would not shake the fundamentals of the contract;

(c) The local borders in India were sealed for a very short period of time during the lockdown period for transport of non-essential goods and services, and cannot relieve the Seller from performing its obligations of delivery of those goods, which were already manufactured;<sup>53</sup>

(ii) It is pertinent to note that in the event, the Seller was successful in performing the contract and the Buyer rejected to purchase the products, the situation would squarely fall under the decision given by the Bombay High Court. The Court recently dealt with a *force majeure* clause in a steel supply contract and held that the *force majeure* clause could not come to the aid of the buyer if the supplier had fulfilled its obligation.<sup>54</sup> According to

the contract, the Respondents, which had its head office in South Korea, were to supply certain steel products to the Petitioner, which were to be shipped from South Korea to Mumbai. The contract contained a *force majeure* clause, however, the Petitioners had raised a contention that in view of the COVID-19 pandemic and the lockdown declared by the Central/State Government, its contract with Respondent No. 1 was terminated as unenforceable on account of frustration, impossibility and impracticability.

The Court held that firstly, the *force majeure* clause was applicable only to Respondent No. 1 and could not come to the aid of the Petitioners, and secondly, Respondent No. 1 had complied with its obligations and performed its part of the contract and the goods had already been shipped from South Korea. The fact that the Petitioners would not be able to perform its obligations so far as its own purchasers are concerned and/or it would suffer damages, is not a factor, which could be considered and held against Respondent No. 1. It was also noted that steel had been declared as an essential service, and the lockdown would be for a limited period and the lockdown could not come to the rescue of the Petitioners so as to escape from its contractual obligations with the Respondent No. 1 of making payments.

(iii) In light of the above analysis, it can be said to be a case of breach of a contract due to reasons of increased burden to perform the contract rather than impossibility to perform the contract. The burden has increased due to the spread of the virus. It is because of COVID-19 that workmen are not showing up at factories, cargo aircrafts/ships are not being attended, etc., which may cause delay in import of parts. However, there is no prohibition on such import by the Indian Government. The case study makes a classic case of a mere breach of a contract by the Seller,<sup>55</sup> except that it happened during the times of COVID-19. In view of the above circumstances, the Buyer may be able to claim damages against the Seller, assessment, and quantification of which are dealt in detail subsequently in this article.

<sup>53</sup> [https://prsindia.org/files/covid19/notifications/2665.IND\\_Clarification\\_Lockdown\\_Transportation\\_April\\_12.pdf](https://prsindia.org/files/covid19/notifications/2665.IND_Clarification_Lockdown_Transportation_April_12.pdf).

<sup>54</sup> Standard Retail Private Limited v. M/s. G.S. Global Corp. & Ors., in Commercial Arbitration Petition (L) No. 404 of 2020 (order dated April 8, 2020).

<sup>55</sup> Herein the notifications mentioned in footnote 50 above issued by the Ministry of Finance, Department of Expenditure Procurement Policy Division may have persuasive value wherein restrictions causing the lack of manpower has been considered as one of the situations which allows for return of performance security, or for extension of the date of completion of contract. An extended application of this principle may allow for condonation of delay, extension or return of performance securities, but may not relieve the parties of their contractual obligations in its entirety.

### E. DAMAGES IN CASE THE RESPONDENT’S<sup>56</sup> BREACH IS ESTABLISHED

In the earlier half of the article, the co-authors have provided a summary of the contractual provisions and protection businesses and governments might consider in managing and minimising any negative consequences arising from non-performance of their obligations.

In the remainder of this article, we consider issues that might arise when quantifying economic damages in disputes in the context of the COVID-19 pandemic. We do so by again developing the hypothetical example described earlier. For the purposes of our example, we assume that the Seller has been found liable for breach of contract and other applicable contractual provisions. Therefore, the relevant question might be on the economic loss suffered by the Buyer.

Below, we first summarise the overall framework that might be considered for assessing the Buyer’s loss. We then describe the key inputs that are relevant to assessing such loss and how such inputs might be impacted due to the COVID-19 crisis.

#### Framework for assessing damages, given the current crisis

The objective of awarding damages is to adequately compensate the injured party for the loss suffered by them because of alleged breaches. A common approach is to measure damages by reference to the sum required to place the injured party in the economic position it would

have occupied “*but for*” the alleged wrongful acts or omissions committed by the other party. This framework gives rise to the lost profits approach.<sup>57</sup> That is, an injured party’s profits are lower than they would otherwise have been, absent the alleged breaches.

Lost profits are measured by comparing:

- (i) The profits<sup>58</sup> that the injured party would have earned, but for the alleged wrongful acts of other party (the “counterfactual position”); and
- (ii) The profits that the injured party actually earned as a result of the alleged wrongful acts of the other party (referred to as the “actual position”).

The difference between the two positions being the injured party’s loss.

The profits in the two positions are projected over the affected period – usually running from the date of the alleged breach to an estimated end of the loss period (which might be driven by contractual considerations and/or economic factors). The profits are then brought forward (using an appropriate interest rate) or discounted back (using an appropriate discount rate) to calculate the present value of such profits (and in turn the injured party’s loss) as at the date of assessment.<sup>59</sup>

Figure 2 illustrates the lost profits approach – the shaded grey area being the loss suffered by the injured party.

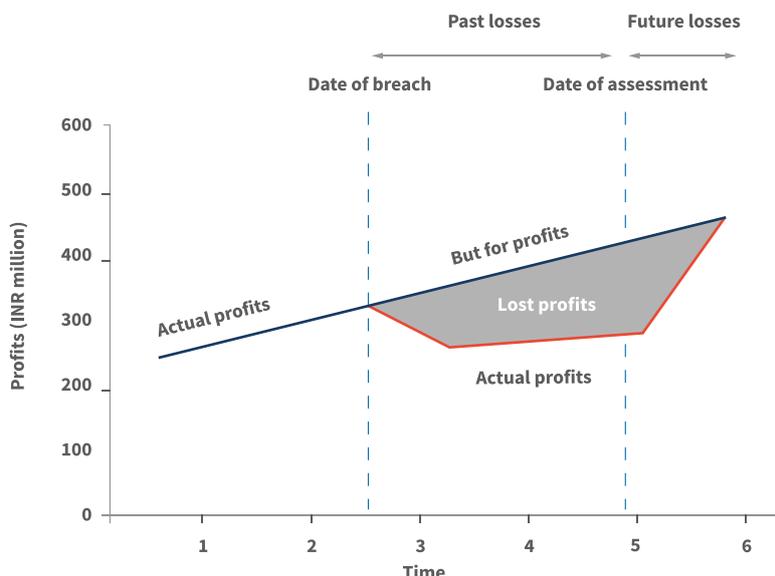


Figure 2: Lost profits framework

<sup>56</sup> Seller, in context of the illustrative case study.

<sup>57</sup> Losses might also be assessed using alternative frameworks and approaches (including wasted costs approach). The focus of this article is on the lost profits approach.

<sup>58</sup> For simplicity, we use the term “profits” here and in other parts of this article. However, valuers typically assess lost profits based on cash flows which is derived from the business’ accounting profits adjusted for, inter alia, non-cash items and other cash inflow or outflows not properly considered in calculating accounting profits. This distinction is not relevant to this article.

<sup>59</sup> This is because often an injured party’s loss includes both historical losses (accruing to the party before the date of assessment) and future losses (accruing to the party after the date of assessment to an estimated end of the loss period).



There are four important considerations when using the lost profits approach:

- (i) First, losses are assessed as at a particular date. This in turn is based on the facts known or knowable as at that date and valuers are usually not allowed to consider any further information beyond the date of assessment.
- (ii) Second, the injured party's loss requires a credible projection of profits under both the counterfactual and actual positions over the affected period. Importantly, the difference between the two positions should reflect the sales or costs affected by the alleged breaches and not on account of unrelated events (for example, external events and market factors).
- (iii) Third, the appropriate discount rate used to translate future profits into their present value recognises the risk associated with receiving those profits in the amounts and within the time expected. The use of a discount rate therefore recognises: (1) time value of money (i.e. an INR received tomorrow is worth less than an INR received today); and (2) the uncertainty (or risk) attached to future profits. The value of an INR that is expected to be received but is uncertain (the amount actually received could be more or less than an INR) is less than the value of an INR that will be received for certain.
- (iv) Fourth, it is often necessary to consider any mitigation steps that the injured party might have undertaken to reduce its loss. Such steps might include entering into alternative contracts and/or filing of a business interruption insurance claim by the injured party.

## F. APPLICATION OF LOST PROFITS TO THE CURRENT CASE

In our current example, the injured party is the Buyer (as claimant) and the other party is the Seller (as respondent). The Buyer alleges that the Seller's breaches relate to, first, non-supply of the Goods under the contract during the period February to March 2020 and, second, the wrongful termination of the contract in March 2020.

On this basis, the Buyer's lost profits might include both: (1) the additional profits it might have made during the period under consideration, absent any non-supply of the Goods under the contract; and (2) the additional profits it might have made after March 2020 up to the expiry of the contract. That is, the Buyer might have earned higher profits from sale of the Goods had the Seller continued to provide the agreed quantities at the agreed price.

In the subsection below, we discuss some of the key inputs and assumptions that might impact the Buyer's loss calculation. Even during normal times, these factors require considerable investigation and examination. However, due to the extent of uncertainty and volatility caused by COVID-19, these factors likely require more careful consideration.

### Date of assessment

As briefly discussed above, losses are assessed as at a particular date (referred to as the date of assessment). The appropriate date is a matter of law, informed by the relevant facts of the case. The date of assessment is important as valuation of losses are often forward looking and are therefore based on the facts known and expectations held (known or knowable) as at a specific date.

In our example, the date of assessment might be:

- (i) The date of the first breach by the Seller under the contract, i.e. February 2020 (when the Seller failed to supply the Goods in the month of February 2020 for the first time since the execution of the contract); or
- (ii) The date of termination of the contract by the Seller, i.e., March 2020; or
- (iii) The date of filing of request for arbitration by the Buyer, i.e., April 2020; or

(iv) A more current date close to the submission of any evidence (including expert evidence) or the presumed date of hearing/award, i.e., say July 2020.

The choice of assessment date will influence the factors, information and events (both macro-economic or company and contract specific) that a valuer might include and consider in his/her calculation.

Valuations may move markedly over time depending on volatility in the underlying business assets and operations, the capital structure of the business, changes in the regulatory regime, exchange rates and inflation rates, and movements in capital and commodity markets. As noted in Part B above, recent events have contributed to such volatility.<sup>60</sup> The awareness, evolution and spread of Covid-19 has (negatively) impacted business and economic activities and forecasts of such activities going forward. For example, as mentioned earlier, on 9 January 2020, the IMF projected that the Indian economy would grow by 5.8 percent in FY2021. It revised its estimate down to 1.9 percent on 6 April 2020.<sup>61</sup> As per the current estimates produced in May 2020, many organisations now expect the Indian economy to contract by up to 5 percent in FY2021. Similarly, the consumer durables sector in India is forecast to grow between 2 percent and 3 percent in FY2021,<sup>62</sup> compared to the growth of 5-6 percent in FY2020, as per CRISIL.<sup>63</sup>

Therefore, in the current example, any loss assessed as in late 2019 and early 2020 - when COVID-19 was more contained and forecast was one of continued growth - might differ quite significantly from the one assessed as at March 2020 or thereafter - when forecast of economic growth and consumer demand had declined.<sup>64,65</sup>

### Profit projections in the counterfactual position

Tribunals and courts are sensitive to the credibility and plausibility of profit projections in the counterfactual position.

Under normal circumstances, a valuer might reasonably assume that the contract would have been performed in the counterfactual position, and therefore, rely on the terms of the contract and use historical cost and price data of the claimant (the Buyer herein) in developing such

<sup>60</sup> <https://www.imf.org/en/Publications/WEO/Issues/2020/01/20/weo-update-january2020>.

<sup>61</sup> <https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>.

<sup>62</sup> This is primarily because India - importing 45-50 percent of finished units and the bulk of components from China - is likely to face significant supply chain disruptions. This is expected to result in increases in cost impacting overall demand of discretionary products (such as refrigerators and air-conditioners).

<sup>63</sup> <https://www.crisil.com/content/dam/crisil/our-analysis/views-and-commentaries/impact-note/2020/march/the-covid-19-fallout.pdf>, and <https://www.livemint.com/industry/manufacturing/covid-19-impact-summer-sales-to-be-a-washout-for-consumer-durable-firms-11586075707788.html>.

<sup>64</sup> <https://www.thehindubusinessline.com/news/covid-19-impact-consumer-durable-firms-hope-for-revival-in-demand-by-may/article31285951.ece>.

<sup>65</sup> Valuers might seek instructions as to whether the use of hindsight is appropriate which varies depending on the exact facts of each case.

profit projections. The current crisis complicates the above assumptions and depending on the date of assessment, it might be necessary to disentangle the effects of COVID-19 from the alleged breaches of the respondent, the Seller. We discuss a few such effects in the paragraphs below.

(i) First, given the scale and scope of the dislocations caused by the pandemic, it is possible that – even absent the alleged breaches – the supply of the Goods at the Buyer’s distribution or warehousing facilities would have been negatively affected. For example, in the period after February 2020 – after the imposition of various restrictions on trade and business activities – supply chains were severely affected. This in turn might have caused disruption in the supply of the Goods to the Buyer (for example, restrictions on movement in non-essential commodities including refrigerators and air-conditioners) and/ or increased the cost of such supply to the Buyer under the contract (for example, due to higher backlogs for transportation services). Similarly, the Buyer’s distribution activities might have also been negatively impacted on account of availability, access and cost of labour and logistical services. Therefore, a valuer might have to consider whether the Buyer would have been able to trade the Goods, even if the Seller had supplied the Goods under the contract, and at what cost. The Buyer’s historical costs may be an inaccurate guide to the costs it would have incurred, absent the Seller’s breach, during the outbreak.

(ii) Second, it is possible that demand for the Buyer’s products by consumers might have also been negatively impacted by the pandemic. For example, the demand of consumer durables in India is projected to fall by ~40 percent year-on-year during the first quarter of FY2021.<sup>66</sup> Similarly, as noted above, the Indian economy and the consumer durables sector is expected to experience lower growth in FY2021 than previously estimated. Lower demand might also impact prices at which the Buyer might be able to sell the Goods. As before, historical demand and price data – based on periods of less volatility and more certainty – may not be a reliable measure of future demand and prices after the onset of the pandemic. Likewise, budgets or forecasts made prior to the pandemic

are unlikely to be reliable guides to expected financial performance in the counterfactual position. Therefore, a more detailed economic analysis might be required to project future consumer demand. Additionally, a valuer will need to carefully consider contemporaneous forecasts (prepared by the management or other third-party organisations) and determine whether they remain relevant as at the date of the assessment. The collective effect of the above factors might require a careful analysis to reflect:

- (a) the different possible contingent events (or sequence of events) and outcomes (including on account of failures of the business itself, loss of important suppliers, and reduction in demand);
- (b) any transmission effects within supply and value chains that have been disrupted at several points; and
- (c) various other causes affecting the financial performance of the injured party.

The magnitude of the impact of the pandemic will ultimately depend on the size and scale of the affected business, the industry in which it operates and the geographic regions it relies on (both for supply of its raw materials and demand of its final products).<sup>67</sup> A valuer will need to carefully consider the available evidence with respect to the effects of the pandemic on the company in question, and how long those effects are likely to last.

#### Discount rate

As explained earlier, discount rate is used to discount the projected future profits back to their present value as at the date of assessment. The use of a discount rate recognises both: (1) compensation for the time value of money; and (2) compensation for risk. By making an investment, an investor is giving up a certain amount of money for an uncertain return.

Often valuers use the affected firm’s or investment’s weighted average cost of capital (“WACC”) as the appropriate discount rate. WACC represents the blended cost of all the capital (debt and equity) invested in a firm.

The inputs to WACC are often estimated using financial market and macroeconomic data. For example, cost of

<sup>66</sup> <https://www.thehindubusinessline.com/news/covid-19-impact-consumer-durable-firms-hope-for-revival-in-demand-by-may/article31285951.ece>.

<sup>67</sup> For example, businesses dealing in ‘essential’ commodities and services (including, inter alia, hospitals, food products, groceries, medicines, telecommunication and media) might be relatively less impacted by COVID-19 than ‘non-essential’ businesses (including dine-in restaurants, gyms and sports clubs, schools, hospitality services, retail stores and malls (non-food), cinemas, manufacturing units and public transport).

<sup>68</sup> Or other market proxies and benchmarks of such debt. Alternatively, often data from the affect firm’s financial statements is also considered in calculating its cost of debt.

debt capital can be calculated based on the prices and yields (interest rate) of a firm’s publicly traded debt.<sup>68</sup> Similarly, the cost of equity capital is often calculated using the Capital Asset Pricing Model (“CAPM”). The CAPM is a commonly applied approach by valuers, investment analysts, bankers and academics. The standard assumptions for the key inputs to CAPM (namely, the risk-free rate, beta, the equity risk premium and the country risk premium) are based on capital market data, including the performance of the stock market indices and share prices of listed firms.

As with the profit forecasts, the current crisis raises a number of key issues in measuring an appropriate WACC.<sup>69</sup>

A firm’s cost of debt (interest) reflects returns that lenders require to compensate them for, both time value of money and the default risk associated with the borrower. The lender loans an initial amount (the “principal”) and in return receives compensation in the form of interest as well as the repayment of the principal on a timing that is typically pre-agreed.

As figure 3 below shows, the yield (the prevailing market

interest rate) on US five-year corporate bond has been rather volatile, particularly, for corporate bonds with lower credit rating (for example, B and CCC rated bond). Firms with higher credit risk (and in turn lower credit ratings) appear to have been most affected, with yields increasing by 420 to 470 basis points (or, 4.2 percent to 4.7 percent) between 1 January 2020, and 1 April 2020, before declining again. That is, during the period January 2020 to April 2020, it became expensive for such firms to raise debt against the background of increasing risks and investors seeking higher returns for lending capital. What the figure below also shows is that borrowing for the highest rated debt has actually decreased as investors seek safer investments during the current crisis.

Going back to our case study, a valuer will need to be careful in computing the appropriate cost of debt for the Buyer – taking into account the current market conditions, Buyer’s credit rating (and to what extent that has been affected by the current crisis) and the price of credit risk (as measured by yield/interest rate) over the term of the contract.

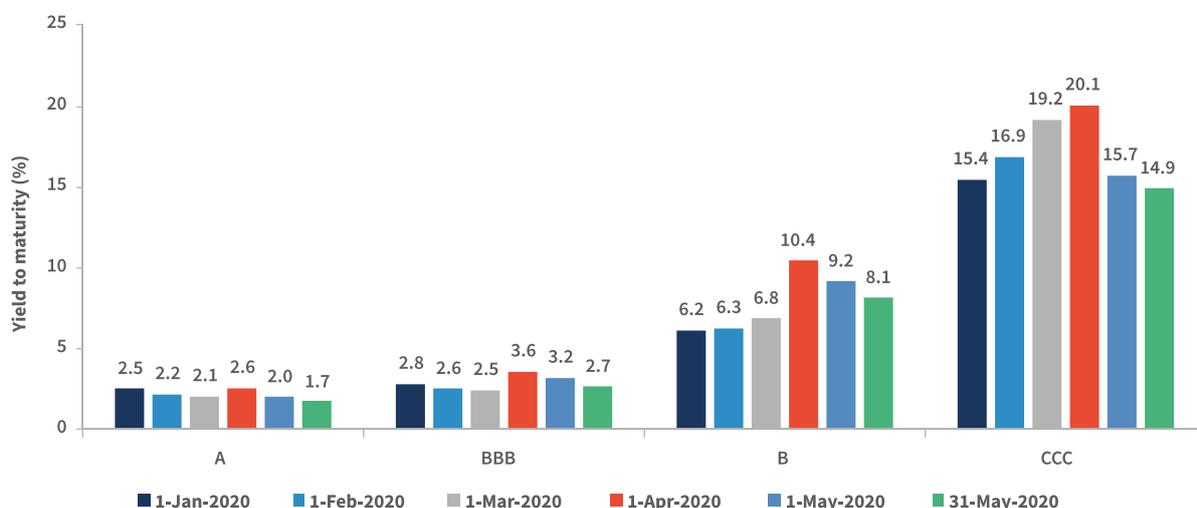


Figure 3: US five-year corporate bond yields by credit rating<sup>70</sup>

<sup>69</sup> The authors have not sought to undertake an exhaustive and detailed discussion and review of the relevant issues which are complex and large in number. This is outside the scope of the current article. Instead, they have focused on summarising the key issues that are likely to be relevant in estimating the appropriate discount rate.

<sup>70</sup> S&P Capital IQ.

Similarly, inputs to cost of equity are based on financial market data and recent (increased) volatility in financial markets will need to be carefully analysed prior to computing an appropriate cost of equity over the term of the projected cash flows.

For example, the risk-free rate in the CAPM is the return on a security with no, or virtually no, default risk. In practice, the yields of developed country government bonds with maturity and currency consistent with those of the project profits are frequently used as proxies for a risk-free rate. The United States government bonds are often the most used benchmark for the risk-free rate. The US risk-free rates reduced from 1.92 percent in January 2020 to 0.64 percent in May 2020; a decline of around 70 percent. This was primarily because of deteriorating market conditions and expectations of future growth coupled with an increase in demand for safe investments (often termed as flight to quality)<sup>71</sup> and the effects of actions taken by the Federal Reserve, including the USD 700 billion quantitative easing programme<sup>72</sup> announced in March 2020.<sup>73</sup>

A valuer might choose to use the current spot rates, reflecting the current returns available on risk-free securities or, as some valuers argue, use a 'normalised' (increased) risk-free rate – often based on longer term historical averages – to reflect a more appropriate rate over the forecast period in the valuation. Neither approach is without debate, but notwithstanding the approach adopted, consistency between the various inputs to the cost of capital will be critical.

Similarly, other inputs (such as beta, equity risk premium and country risk premium) are based on the performance of the wider stock market indices and traded securities (such as government bonds and listed firms' stock returns). Recent heightened volatility might impact any calculation of such measures to the extent they rely on historical data. For example, the standard deviation<sup>74</sup> (a common measure of risk in corporate finance) of the daily returns of the BSE 500 index between 1 January 2020, and 29 May 2020, was 2.3 percent.<sup>75</sup> This compares to 0.8 percent over the same period in 2019. Similarly, the rating based default spread between the US and India government bond yields – often used as a proxy for the additional risk associated with investing in India over

more developed markets like the US – increased from 1.59 percent on 1 January 2020, to 2.82 percent as on 1 April 2020.<sup>76</sup> Both these developments suggest that the risk of investing in Indian business has increased since January 2020. Therefore, inputs calculated based on capital market data might be particularly sensitive (rightly or wrongly) to the period considered in the calculation.

As before, in the case of Buyer, a valuer will need to be careful in choosing the appropriate approach and period for calculating the various inputs to Buyer's cost of equity and importantly if the chosen inputs appropriately reflect the risks attaching to Buyer's projected profits over the affected period.

### Mitigation

It is often incumbent on the injured party to take reasonable steps to mitigate its losses. The extent to which the injured party has (or could have) performed its duty in this regard is a matter of legal consideration informed by the underlying facts. To the extent such steps could have been taken by the injured party, but were not, it may be appropriate to consider the effect of those potential actions in the loss calculation.

It is possible that in the context of the widespread disruption in economic and business activities, mitigation of losses might be more challenging and difficult. However, that does not necessarily absolve the Buyer from making efforts towards mitigating losses.

Some key questions that a valuer might need to address with his/her counsel include:

- (i) Were there other potential suppliers of the Goods that could have supplied to the Buyer over the relevant period?
- (ii) Could the Buyer have used such alternative suppliers for the remaining period under the contract?
- (iii) If so, what would have been the cost of such alternative supply to the Buyer? Would it have been economically viable for the Buyer to incur such costs?

To the extent, the Buyer did (or could have) reasonably mitigate its losses, the Buyer's loss calculation will need to reflect the effect of such mitigation steps.

<sup>71</sup> There is an inverse relationship between price and yield of a bond. With increase in demand, price increases and yield falls.

<sup>72</sup> The quantitative easing programme involves purchase of long-term securities by the central bank from the open market to increase the money supply in the economy for lending and investment.

<sup>73</sup> <https://www.cnbc.com/2020/03/15/federal-reserve-cuts-rates-to-zero-and-launches-massive-700-billion-quantitative-easing-program.html>.

<sup>74</sup> Standard deviation measure the amount of variation or dispersion in the sample set. In this case, it refers to the variation in the daily returns of the BSE500 index.

<sup>75</sup> Standard deviation increased to 5 percent during March 2020.

<sup>76</sup> As estimated by Professor Damodaran, Professor of Finance at the Stern School of Business at New York University. Source: <http://www.stern.nyu.edu/~adamodar/pc/datasets/ctrypremApr20.xlsx>.

## G. CONCLUSION

It is clear that the health and economic impact of COVID-19 is extensive. This has necessitated unparalleled steps and actions by governments globally, including social distancing measures and severe restrictions on trade, travel and economic activities. These measures are likely to affect businesses' ability to perform their contractual obligations, resulting in disputes.

In the first instance, parties are likely to consider risk mitigation strategies available to them by way of exercising their rights under a contract, or doctrine of frustration available to parties as per the Law of Contracts. However, in order to ascertain the applicability of a *force majeure* clause in a contract or the doctrine of frustration, one ought to mandatorily analyse the ambit of such a clause and whether the same will be applicable to the extraordinary event being contested as a *force majeure* event. The said analysis must be undertaken on a case-to-case basis and no over-arching principle may be applicable to contractual clauses.

Separately, quantifying economic damages in disputes against the background of the COVID-19 pandemic will likely require particularly careful analysis. The financial and economic consequences of COVID-19 and the resulting increased volatility in the financial markets have introduced additional challenges to the implementation of the standard approach to damages calculations. Such challenges might relate to forecasting profits of the injured party in the counterfactual position, and/or estimating an appropriate discount rate to calculate the injured party's loss as at a particular date. The length and magnitude of the impact of the pandemic on the above factors will depend on the nature and size of the affected business, and the industry and geography in which it operates. Valuers will need to address the additional complexities and disentangle the effects of COVID-19 from the effect of the alleged breaches under the disputed contract.

These are unprecedented times and all stakeholders in a dispute ought to ascertain their best foot forward while claiming/defending one's case.

*Note: This article is subject to changes in applicable laws from the date of the publication and any contrary view that may be taken by any Indian court or any governmental/regulatory authority on issues considered by this article. This article does not contain any legal opinion on dispute strategy or outcome of any claims or potential claims by a buyer/supplier against a supplier/buyer and the content of this article do not necessarily reflect the views/position of Cyril Amarchand Mangaldas but remain solely those of the authors.*

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