

# COVID-19: Commercial Risk Mitigation & Damages Claims in Africa

Economic Financial Consulting

Businesses operating in Africa are facing significant financial headwinds caused or exacerbated by COVID-19 and the associated government measures imposed. In a recent webinar, in collaboration with Cliffe Dekker Hofmeyr Inc and international experts in law, we provided some insight on navigating commercial risk and financial hardship during these unprecedented times in Africa, including discussing methods of efficiently and effectively resolving the inevitable commercial or investments disputes.



Companies need to be careful not to simply invoke force majeure without careful consideration of whether the force majeure event and the impact on their business has meant it has been impossible to perform their obligations under the contract.

In this note, the takeaways from the part of this webinar considering commercial disputes from an accounting and finance perspective are set out, focusing on force majeure, hardship provisions, and considerations for damages claims that may arise in these challenging times from breach of contract. Otherwise companies could be found to be in breach of contract.

## Force majeure clauses

The legal experts explained in the webinar some of the steps companies should take in reviewing their contracts, and in particular whether contracts include a force majeure clause and what it entails.

To help manage this risk, it will be important for the parties to have taken reasonable steps to try and reduce and mitigate the effect of the force majeure event. Parties should keep a documentary record to evidence such effects, including why performance has been impossible, the costs that have been incurred as a result of the event, and the steps taken to mitigate the effects of the event. Colleagues at FTI Consulting South Africa share further insights on this topic here.

## Hardship provisions

Hardship provisions may be seen in long term supply agreements, for example, ones involving the supply of raw materials. They may give a party who is suffering financial hardship various options in relation to non-performance.

As explained at the webinar by the legal experts, from an economic and accounting perspective, the first step for evidencing hardship would be to examine the accounting records and financial performance. However, there are a number of other issues that may need to be considered. Some of these issues may be informed by contract terms, but could include:

- **Period of assessing losses** – whether the period is of sufficient length to evidence that hardship has been or will be suffered.
- **Cost measurement** - whether costs should be measured under accrual-accounting (i.e. the measure used in a company's profit and loss account) or under the cash basis.
- **Cost allocation** - if the company has more than one business line, questions may arise over how to allocate common costs (such as head office costs ) to the relevant business line.
- **Efficiency** - one party may argue that the alleged hardship has been caused by inefficiencies and not from unforeseeable events out of the control of the parties.
- **Mitigation** – similar to considerations of invoking force majeure, it will be important to consider what steps have been taken to mitigate losses resulting from the alleged hardship event.

Again it will be important to keep thorough documentary evidence and records, to help establish the cause and extent of hardship.

“There will be legal hurdles to overcome, such as evidencing that the events leading to hardship were outside the parties’ control and not foreseeable when the contract was entered to.”

## Potential breach of contract

In these challenging times, if a company is not able to rely on force majeure or a similar provision, it may risk being in breach of contract for non-performance and face a damages claim.

In a damages claim, a claimant may seek compensation for the profits it would have earned had the obligations under the contract in dispute been performed by the other party. The damages (or lost profits) are usually quantified by reference to the difference between the financial position the claimant would have been in if the contract had been performed (the But-For Position) and the position the claimant in fact occupies as a consequence of the other party's actions.

### *The But-For Position and the assessment date of damages*

A key element of the damages calculation is the But-For Position. It is important that this position is plausible, consistent with the facts and evidence available at the time, and intuitive to accept.

The But-For Position can be significantly affected by the date at which damages are assessed. This date is typically either when the breach occurred or is as at the hearing/trial. Assessing damages at the date of breach should restore the claimant to the financial position it would have been in ‘but for’ the breach, using information only available at that time. If the breach occurred before the outbreak of COVID-19, for example, the But-For Position should be based on projections of financial performance excluding any effects of COVID-19 on the business. However, if the assessment is at the date of hearing, information that becomes available between the date of breach and the date of hearing, such as the outbreak of COVID-19, needs to be taken into account. Given many businesses have suffered from the effects of COVID-19 and the associated government measures, the timing of the assessment may have a material effect on the damages claimed.

The assessment date is ultimately a matter of law. Under English law, it is said that the general rule is to assess damages for breach of contract at the date of breach. However, there have been a significant number of exceptions to this general rule. The date chosen can be a complex issue, dependant on the facts and the specifics of the case, but in particular on whether the Court or Tribunal considers that events (e.g. the COVID-19 crisis) occurring after the date of breach should be taken into account in the But-For Position and the damages assessment.

An example of a case where information available at the date of trial was taken into account in the damages assessment was *The Golden Victory*. In this case, a seven-year ship charter agreement was repudiated before a force majeure event, the outbreak of war, occurred. The House of Lords decided that damages for breach of contract could only be claimed from the date of repudiation to the outbreak of war, rather than over the full remaining term of the agreement.

The reason was that the claimant would not have benefited from the contract once war commenced, and should not be placed in a better position than if the contract was actually performed. However, this decision was not unanimous; two of the five Lords adjudicating considered that damages should be assessed at the date of breach, and hindsight information should be excluded. This suggests that the selection of the damages date could be a highly contentious issue in cases where a company may have relied upon COVID-19 or its effects as a force majeure event, but breached a contract before the outbreak.

For example, for the glass bottle manufacturer, if the projected cash flows reflect the effect of the alcohol ban on sales, this effect (or risk) does not also need to be taken into account in the discount rate. Otherwise, a valuer will double count the risk and understate the value of lost profits.

#### *Mitigation – the claimant’s obligation*

One other important area to be aware of is mitigation. In most legal jurisdictions, the claimant in a breach of contract dispute has a duty to mitigate any loss it has incurred.

#### *The But-For Position – discounted cash flow analysis*

In a lost profits claim, typically the But-For Position of the claimant is assessed using a discounted cash flow (DCF) analysis. This is where the expected cash flows that would have been earned by the claimant had the contract been performed are projected, and discounted back to a present value lump sum as at the assessment date using a reasonable discount rate.

For the cash flows, it is important for a valuer to make realistic projections. If the assessment date of damages is after the COVID-19 outbreak, due to the effects on businesses and future uncertainty, making these projections will likely be a complex exercise.

In establishing the But-For Position a valuer may assume that the obligations under the contract in dispute would have been performed. However, the other effects of COVID-19 on the business still need to be taken into account.

For example, if a manufacturer of glass bottles in South Africa is claiming against one of its suppliers for failing to supply materials, the But-For Position of the manufacturer should take into account the effect the reduced sales caused by the alcohol ban would have had on its business.

On the discount rate, there are usually several inputs that need to be assessed. These inputs are not discussed in this article, but one general pitfall to be aware of is the double counting of risk. The expected cash flow projections should typically reflect relevant specific risks affecting the business, and such risks should not also be reflected in the discount rate.

## How FTI Consulting can assist

FTI Consulting can provide independent expert accounting, finance and economic advice and litigation support, whether you are seeking to invoke a force majeure clause or hardship provision, or require assistance with initiating or defending a damages claim due to breach of contract.

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