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COVID-19: Effects on commercial contracts

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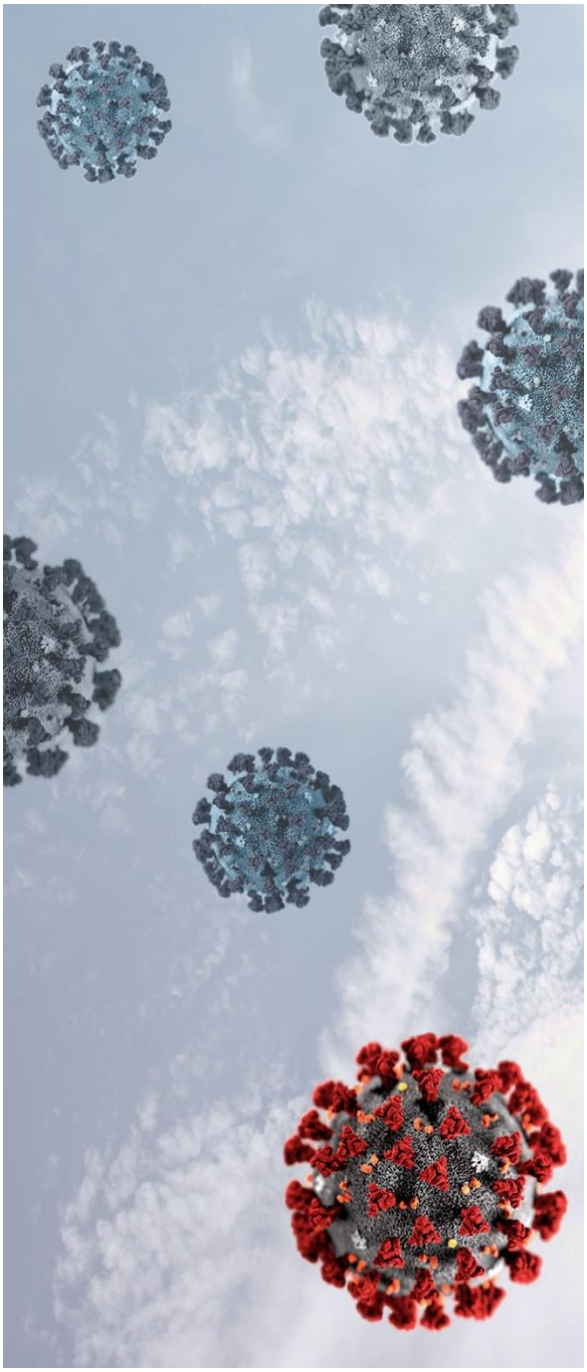

Impact of the COVID-19 pandemic on commercial contracts

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The COVID-19 pandemic has caused enormous disruption to party obligations in commercial contracts.

Shutdown of facilities, obstacles to service provision, production and supply difficulties, difficulties in the rendering of services, stoppage of business, transport problems, a drop in clientele, contractual imbalance, loss of income, changes to business model scenarios, one party's financial difficulties, a frustrated contractual purpose...

These are all issues currently faced by those who are doing business, making it extremely difficult or even impossible to perform contracts. Questions arise: Can we vary the terms of a contract? Can we temporarily suspend contract enforcement? Are there grounds to terminate the contract? Could we demand that the contractual terms be renegotiated? Under what terms could these options apply? To what extent should the parties share the consequences of the circumstances? How much can we demand?

With few exceptions, the effects of COVID-19 on commercial contract performance already in place have not been directly addressed in the extraordinary and exceptional measures that the Portuguese government has implemented. However, broadly speaking, national law offers legal solutions to the questions raised and sets out possible routes for action.

Often, the parties agree in the contracts on special rules to apply in these types of events, and with varying degrees of detail they describe what those events might be, their scope and the repercussions they may have on the contractual arrangement.

To determine which solutions apply to the case at hand, and their consequences, the contract needs examination to determine whether the parties have put in place a specific mechanism and what that might be. If there is no specific and acceptable contractual provision to protect the parties, the law will dictate the responses required.

Obviously, these scenarios are not watertight. Contractual arrangements must be coordinated with the legal framework, so deciding whether it was the parties' intention to reject them (fully or in part), develop them or make them more specific, and whether it was valid to do so, must be considered on a case-by-case basis. There are also borderline situations that may involve more than one set of regulations or may develop from one type to another.

Finding appropriate responses and ascertaining whether they meet the requirements of any of the legal institutes requires a rigorous appraisal of all the specific circumstances in each case.

In this bulletin, we briefly describe the legal framework of impossibility of performance and change of circumstances, and the contractual clauses regulating *force majeure* and material adverse changes.

➢ IMPOSSIBILITYOF PERFORMANCE

Under article 790 of the Portuguese Civil Code (*Código Civil*), "*The obligation ceases to exist when a provision becomes impossible for reasons non attributable to the debtor.*" This impossibility may be attributable to the creditor, *force majeure* or fortuitous event, a third-party act or the law itself.

The impossibility of performance must be objective, i.e. not only for the debtor but for any third party. It must be absolute — i.e., unfeasible: a merely relative impossibility constituting heightened difficulty of performance would not be sufficient. Lastly, it must be definitive, so a merely temporary impossibility of performance would not be sufficient.

As such, a mere relative or temporary impossibility of performance do not break the contractual relationship, although it could be grounds for other legal recourse.

Once the objective, absolute and definitive impossibility of performance of the contractual services has been confirmed, the obligation will cease to exist, and the party will be released from the obligation to render them. As a result, the counterparty to the contract loses the right to demand performance and indemnification for the breach.

In any of the situations where *force majeure* has been proven (by law or as defined in the contract), the party suffering the objective, absolute and definitive impossibility of providing the contractual services due to the COVID-19 pandemic must notify the other party by the stated deadline, to reduce as far as possible the damage suffered by the latter, and to provide justification.

➢ TEMPORARY IMPOSSIBILITY OF PERFORMANCE

If the impossibility of contract performance is merely temporary, the obligation of the affected party will be suspended until the constraint is removed, during which time the counterparty may not demand performance or claim damages suffered by the delay, such as late-payment interest.

➢ PARTIAL IMPOSSIBILITY OF PERFORMANCE

If contractual performance is partially impossible due to *force majeure*, the party can be exempted of liability by providing the services it can, and by reducing the scope of the contract and the respective consideration. Should the counterparty not be interested in partial performance of the contract, it may opt to terminate it unilaterally.

➢ CHANGE OF CIRCUMSTANCES

Under articles 437 to 429 of the Civil Code, change of circumstances rules may apply where due to an abnormal change in the circumstances in which the contract was originally entered, there is greater difficulty in performing the contract and the provision by one of the parties suddenly and unexpectedly becomes so onerous that enforcing that provision would seriously harm the principles of good faith. These rules may include contract amendment, by adjusting the amount or imposing a moratorium on performance, and ultimately, termination.

➢ *FORCE MAJEURE* CLAUSES

According to leading academic legal argument and case law, "*inevitability underpins the case of force majeure: any natural occurrence or human action that, even if foreseeable or anticipated, cannot be avoided nor its consequences escaped.*"[1] *Force majeure* usually applies to extreme situations or external events whose responsibility may not be attributed to any of the parties.

In situations where the parties have expressly provided for cases of *force majeure* in the contract, the only way to ascertain whether it was the parties' intention for the clause to cover a pandemic such as the one we are experiencing is to interpret it and its effects on contractual performance. It is commonplace for *force majeure* clauses to include the consequences of a verified case (suspension or termination of the provision, an extended period for performance, reduced provisions for the parties or other changes to the contractual schedule). If the contract is interpreted in a way that the clause does apply to the COVID-19 pandemic, the effects will be *prima facie* as regulated by the parties.

However, naturally, it falls to the party arguing the *force majeure* as grounds not to perform the contract to prove that it exists. That party must prove the link between the alleged grounds and the non-performance. Alleging and demonstrating that performance has become more difficult or onerous does not go far enough; it must be shown that it has become impossible to perform the contract, e.g., because there is no other way of providing the agreed services.

However, if the contract does not provide for *force majeure* (or where there is a *force majeure* clause but it can be concluded that the parties did not intend to waive the legal recourses available), the law applicable to the contract will apply.

[1] See Supreme Court Judgment of September 27, 1994, at www.dgsi.pt.

➢ MATERIAL ADVERSE CHANGE ("MAC") CLAUSES

MAC clauses are often included in international contracts, particularly in transactions sector, due to the influence of common law. Following the 2008 financial crisis, the use of these clauses spread throughout the mergers and acquisitions market.

As a result, where contracts have been entered into for the acquisition of companies or assets, but they have not been closed due to being subject to certain conditions that are yet to be fulfilled, buyers must reassess the text of those clauses to determine whether they apply in the current pandemic.

These clauses give parties the right to withdraw from the contract in the event of a "material adverse change" between contract signing and closing. The definition of "material adverse change" varies, but it is often determined by a reduction or devaluation of certain financial indicators (e.g., EBITDA or gross turnover), as a result of events or circumstances that have a disproportionate effect on the business of the company that is the object of the contract.

Given our ignorance of the medium to long-term effects of COVID-19 on the economy and company profits, contractual termination based on an MAC clause should be considered with great care. If such a termination were to be examined by a court, it would fall on the party relying on it to withdraw from the contract to prove the existence of grounds.

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Cuatrecasas has set up a Coronavirus Task Force, a multidisciplinary team that constantly analyses the situation emerging from the COVID-19 pandemic. For additional information, please contact our taskforce by email TFcoronavirusPT@cuatrecasas.com or through your usual contact at Cuatrecasas. You can read our publications or attend our webinars on our website.

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