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COVID-19 | Legal Insights no. 9

Impact on commercial contracts

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Content

Content

1# Brief Background

On 11th March 2020, the World Health Organization classified the spread of COVID-19 disease caused by the new coronavírus as a pandemic.

This has serious, direct and indirect, repercussions on several contracts, causing a huge impact on business activity.

Most of the problems concern to the application of the impossibility and change of circumstances regimes or to the application of specific contractual provisions.

The intention is to briefly identify these regimes that frame cases of impossibility, temporary or definitive, total or partial, of escalation of the obligations' fulfiment and of contractual imbalance, applicable in these cases which affect the entirely contracts' fulfillment, motivated by COVID-19.

2# Summary

- At a first stage, it is necessary to ascertain if the commercial contract entered into by the relevant parties includes any contractual disposition in which the current coronavirus pandemic situation may be framed under, and to evaluate the feasibility to invoke the force majeure clause, clauses regarding the change of the circumstances or term suspension, once verified certain circumstances and/or even hardship clauses, under which the parties undertake to renegotiate the content of the contract in view of a fundamental event, causing change to the agreed balance.

- A clause that provides the abovementioned situations shall be observed, including in what regards to any obligations to notify the counterparty, as well as to adopt additional measures foreseen in the contract.

- The party aggrieved by the contractual imbalance or by any foreseen situations, including force majeure events or contractual imbalance due to extraordinary onerosity or excessive difficulty in the performance, shall:

  (i) Ensure to take all measures within its power to avoid or minimize the non-compliance, provided that the measures agreed between the parties or the solutions arising from the law are not abusively invoked;

  (ii) Verify if there are other causes besides the current coronavirus pandemic situation that may contribute to the impossibility to comply or to the extraordinary onerosity or excessive difficulty in the performance of the contract;

  (iii) Negotiate with the counterparty, in order to try to reach an agreement, which may result in the contract modification, or termination (by the parties' agreement), namely with regard to terms or even to the cost.

- Within this context, it shall be also important to measure the situations in which any provision resulting from published legislation and issued in response to the emergency situation created by COVID-19 may be directly or indirectly applied to the contract.

2# Summary

- Force majeure events, under the general applicable Portuguese law, shall only be invoked if the aggrieved party is in a position to prove them, and as long as it is aware of the risks inherent to this claim, namely with regard to the possibility of the aggrieved party to have to return to the creditor what has been received (for example the price); in case the return is not feasible, the possibility that the creditor, for example, demands the compensation that the debtor has received from an insurance company due to an insurance agreement.

- In case of an impossibility of compliance not solely motivated by the pandemic or if the compliance seriously affects the contractual balance, the principle of good faith in the execution of contracts, and the principle of equitable reduction as a general principle of Law, which materializes good faith in the execution of the contract (provided that the respective premises have been verified) shall be considered to be invoked, as well as the possible activation, invocation and proof of the modification or termination of the contract due to change of circumstances, provided that the respective requirements are cumulatively fulfilled.

- In any case, it is always advisable to analyse the situation from concrete technical legal perspective, in order to evaluate, in the specific case, which are the best measures to minimize the risks and losses to each of the parties, considering all the interests involved.

3# The impossibility to comply with the commercial contract not attributable to the debtor – contractual provisions

3.1# Private autonomy and contractual freedom. The parties' self-regulation of interests and the analysis of the concluded contract

Under private autonomy, the parties are free to self-regulate their interests and to settle the clauses which, considering the business at stake and their experience, are the most adjusted and best suited for the purposes they seek to achieve.

Therefore, and first of all, it is important to analyse the commercial contract in hand, concluded (and in force), in order to ascertain whether it sets forth any contractual provision that considers a situation in which the current pandemic could fit in.

It is common the setting of "fortuitous event" or "force majeure event" clauses, material adverse change clauses and even hardship clauses, ruling the applicable regime in case of verification of the relevant premises, as well as the indication of the procedures to be followed, the relevant deadlines, the consequences and also the actions to be taken in order to minimize the consequences of their verification.

As a rule, the impossibility to comply with the contract due to fortuitous or force majeure events exonerates the debtor from any liability. Nevertheless, the parties are free to agree otherwise and may decide on the actual extent of their liability, as well as on the relevant limits.

If the contract does not stipulate any applicable specific provisions, the general legal regime shall be applicable.

4# The impossibility to comply with the commercial contract not attributable to the debtor – applicable legal regime

4.1# General legal regime applicable in Portugal

Rule: Under the terms of article 406, paragraph 1 of the Portuguese Civil Code: "*The contract must be entirely fulfilled and complied with and may only be modified or terminated by mutual consent of the contracting parties or in cases admitted by law*."

Nevertheless, the contract is not always entirely fulfilled and complied with, that is to say, as agreed. It corresponds to non-compliance, which may be a:

(i) non-compliance attributable to the debtor; or

(ii) non-compliance which arises from a cause not attributable to the debtor, the impossibility to comply not attributable to the debtor.

Fortuitous event and force majeur event are causes not attributable to the debtor.

4.2# Fortuitous Event and Force Majeur Event

What is a force majeur event?

The occurence of an unexpected, unavoidable, beyond control event, which precludes the compliance and the full performance of the obligations undertaken under a contract.

The jurisprudence of the Portuguese Supreme Court of Justice has supported that "***The force majeur event has implied the idea of inevitability: it corresponds to any natural event or human action which, altough predictable or even prevented, could not be avoided, either in itself or in its consequence***s".

The following are usually considered as force majeur events: events caused by Nature, social conflicts, including threats or attempts thereof, strikes, hostile acts, military operations, civil requisition, war, acts of terrorism, revolutions, serious epidemics.

What is a fortuitous event?

The fortuitous event is based in the idea of unpredictability, that is to say, the event could not be predicted, but it would be avoided if it had been predicted. On the other hand, the force majeur event, altough it could be prevented, it could not be avoided, either in itself or in its harmful consequences.

Regardless of the meaning in which the expressions fortuitous event or force majeur event are taken, their legal effects are the same, unless otherwise results from the law, exceptionally, or from a negotiated provision.

4# The impossibility to comply with the commercial contract not attributable to the debtor – applicable legal regime

4.3# May the pandemic COVID-19 be considered as a force majeure event, to be invoked as an impediment to contractual compliance?

In general terms, it is defensible that the COVID-19 pandemic may be considered a case of force majeure. However, the specific contractual relationship requires to be analyzed in order to assess the following:

- ❑ Is there a casual link between the event and the non-compliance not attributable to the debtor?
- ❑ The impossibility to comply results exclusively from the pandemic?
- ❑ The party affected by the force majeure event has taken all the possible measures in order to mitigate the effects of the contractual non-compliance?

The answer to these questions may impact the solution. If the answer to the questions is positive, it is more feasible to invoke the force majeur event as an impediment to the contractual compliance.

4.4# Which are the consequences in case the debtor invokes the impossibility to comply with the contract based on a force majeur event?

The debtor may withdraw from the contract, which terminates, without having to indemnify the creditor for the arising damages. Nevertheless, the debtor shall return to the creditor what he received from him (e.g. the price). If the return is not possible, the debtor shall compensate the creditor, or the creditor may, for instance, demand the indemnity that the debtor may have received from the insurance Company, due to an insurance contract (by way of subrogation).

4.5# Over whom relies the burden of proof of the existence of a force majeure event?

Unless otherwise is set forth in the contract, the party that invokes the force majeure event as reason not to comply with the contract is bond to demonstrate that there is a causal link between the force majeur event and the non-compliance.

Is it not enough to claim that that the compliance has become more difficult or more costly. It is required to demonstrate a real impossibility to comply.

4# The impossibility to comply with the commercial contract not attributable to the debtor – applicable legal regime

4.6# And what may the creditor do in case the contract is terminated due to the invocation of impossibiliy to comply based in a force majeur event?

The creditor shall analyse the situation in order to confirm if the debtor is right and if he succedded to duly evidence the existence of a force majeur event, under the general terms or in accordance with the agreed contractual provision, if applicable.

Notwithstanding, if the debtor is able to invoke and prove the force majeur event, as above mentioned, he shall not be bound to indemnify the creditor for the arising damages, however, the debtor shall return to the creditor what he received from him (e.g. the price). If the return is not possible, the creditor may demand the indemnity that the debtor may have received from the relevant insurance company, due to an insurance contract (by way of subrogation).

If the debtor is not right and did not succed to duly evidence the existence of a force majeur event, the creditor may use the available procedures to request the executin of the contract.

4.7# And in case there is solely a partial impossibility to comply with the contract?

In case the obligation is divisible, and in case the impossibiity solely affects a part of the obligation, the creditor may demand to the debtor the performance of the possible part; and, in this case, there shall be a reduction of the relevant consideration.

4.8# And if the creditor loses interest in the fulfillment and compliance of the contract, as a consequence of the debtor (e.g. provider) claiming the temporary impossibility to comply with the contract, based on the pandemic COVID-19?

In such case, and after a thorough analysis of the specific situation, the creditor may terminate the contract, without the liability to compensate the debtor, and may also demand the return of what he has already provided.

4# The impossibility to comply with the commercial contract not attributable to the debtor – applicable legal regime

4.9# And if the compliance is still possible, but it has become excessively costly or implies an amendment or suspension of terms by the affected party (debtor)?

The objective impossibility of the performance (article 790 of the Portuguese Civil Code), as cause for the termination of the obligation is solely the absolute impossibility and not the mere difficulty for the debtor, arising from the extraordinary onerosity or excessive difficulty in the performance. What happens in these cases?

In these cases, and taking into account the particularities of the specific case, we have to consider:

(i) Supervening and inadmisible imbalances arising from the fact that they are excessively costly, although they did not exist at the time the contract was entered into, as the performance was reasonable at that time.

In this case, the party affected by the extraordinary onerosity or excessive difficulty in the compliance may be entitled to request an equitable reduction of its performance, considering the pandemic situation and the circumstances of the specific case, or it may even be entitled to request for the amendment or suspension of the terms for the relevant performance.

It is noted that the invocation of this situation implies a thorough legal evaluation, taking into account the contractual provisions, the supervening specific circumstances and the risks inherent to the contract.

(ii) A situation of abnormal change of the circumstances on which the parties based the decision to contract.

In concise terms, in this case, the party affected by the change of circumstances may be entitled to the termination of the contract, or, alternatively, to the relevant modification in accordance to equity judgment; but solely provided that the compliance of the undertaken obligations severely affects the good faith principles and it is not covered by the risks inherent to the contract.

In order to enable the termination or, at least, the amendment of the contactual clauses, based on the abnormal change of the circumstances, it is required that:

- the occured change does not arise from the predictable development of the situation known at the conclusion date of the contract;
- the demand of the compliance by the aggrieved party severely affects the contractual good faith principles; and
- it is not covered by the risks inherent to the contract.

5# Applicable regime in the event of a disproportionate escalation of the performance, resulting in an unreasonable contractual imbalance

5.1# Contractual unbalance due to extraordinary onerosity or excessive difficulty in the performance arising from the pandemic situation and the circumstances of the specific case and Hardship Clauses

Generally, even though the compliance of a contract becomes more costly for one of the parties, such party continues to be liable to comply with the contract – this rule results from the principle of fulfillment and entirely compliance of the contracts.

For that reason, as regards to international contracts, in a first moment, and, currently, concerning national law, the parties several times anticipate the difficulties to which they might come across within the execution of the contract (specially in the case of long term contracts, in which the contractual risk taken by the parties and the interdependence and the interaction between them is extremely intense), namely by anticipating a possible extraordinary onerosity or excessive difficulty in the performance, establishing clauses under which they undertake to renegotiate the contract in certain circumstances, which are known as hardship clauses.

Hardship Clauses arouse from the execution of long term international contracts, once they also helped overcoming the lack of standardisation of International Commercial Law, on account of the change of the agreed conditions during the execution of the contract.

What are Hardship Clauses?

It is considered hardship the substantial change to the balance of the contract due to several reasons, such as, economic, social, financial, legal, technological, political, or others, that entail harmful consequences to the parties.

In the event of hardship, the aggrieved party has the right to claim the renegotiation of the contract, in accordance with good faith rules, in the relevant execution. The renegotiation shall be performed without undue delays and shall state the reasons under which it is grounded, not conferring, by itself, the right to the aggrieved party to suspend the execution of the contract, unless otherwise has been established by the parties.

5# Applicable regime in the event of a disproportionate escalation of the performance, resulting in an unreasonable contractual imbalance

5.1# Contractual unbalance due to extraordinary onerosity or excessive difficulty in the performance arising from the pandemic situation and the circumstances of the specific case and Hardship Clauses (Cont.)

What are Hardship Clauses (Cont.).

- Hardship Clauses aim the renegotiation, by the parties, of the content of the contract, due to a key event that leads to an imbalance of the contract;
- The renegotiations aim at allowing the parties to reach an agreement to restore the balance of the provisions and the "damages sharing", when certain premises previously established by both parties are verified, and they are ruled by the conditions initially foreseen at the time of the conclusion of the contract.
- Once a hardship clause is established, the parties are bound to renegotiate the contract whenever the event is not covered by the risks inherent to the contract;
- In order to qualify this risk it is necessary to analyse the circumstances that existed at the time of the conclusion of the contract, the sharing of risks in general, the applicable law to the contract and the relevant elements of the contract, in short, to look at the circumstances of the specific case.

6# Applicable regime in the event of impossibility of compliance of an international commercial contract

6.1#International Contract. Short Note.

In accordance with Regulation (EC) no. 593/2008 of the European Parliament and Council, dated from 17th July 2008, applicable to contractual obligations (Rome I), the general applicable rule is that "*the contract is ruled by the law established by the parties*", and this "*choice (…) shall be express or result in a clear way from the contract provisions, or from the circumstances of the case"*.

"According to their choice, the parties may appoint the applicable law to the whole contract or solely to a part of it". In international contracts B2B (business to business, this means, concluded between two companies that do businesses as client and supplier), the parties may choose the applicable law even if the chosen law has no connection with the contract.

In the lack of choice of the applicable law to the contract, the applicable law is determined in accordance with Article no. 4 of Rome Regulation I: "*the contract is ruled by the law of the country to which it has a closer connection*".

The parties have long been drafting clauses that are socially typical, due to the diffusion and prominence that they assume in business practice and due to the standardization and to the regular inclusion in the contracts they conclude, such as material adverse change clauses, force majeur clauses and hardship clauses, as above mentioned. In what regards International Contracts, it is also necessary to assess, in a first moment, what was foreseen by the parties, in accordance with hermeneutical rules.

Please note that this document is solely a general analysis of the Portuguese general regime, applicable in the event of impossibility to comply with the contract or difficulty to comply with it. Should you require further information or any assistance, please do not hesitate to contact the Contract Law team of CTSU - Sociedade de Advogados.

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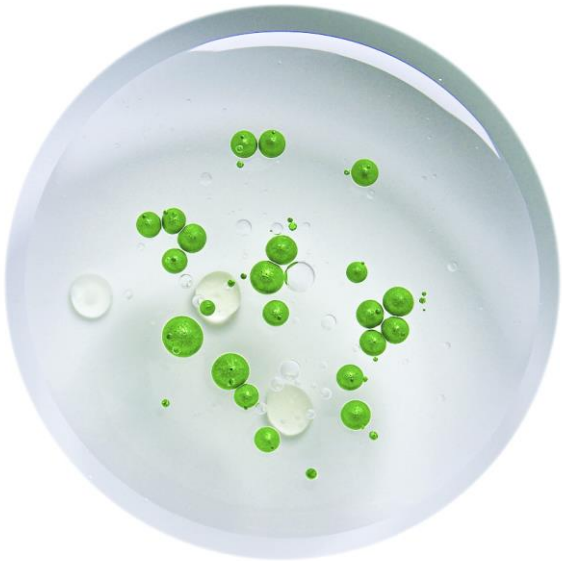

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