CHIOMENTI

Newsletter

Corporate and Litigation Departments
Effects of COVID-19 on contracts

Introduction

The proliferation of COVID-19 in Italy, and the subsequent adoption by its government of a series of restrictive measures aimed at facing this emergency, give rise to reflections on the impact that this situation may have on existing contracts and possible remedies offered by the Italian legal system. Clients are increasingly asking these questions about their contracts and how to manage the impact that this situation could have on future contractual relationships. We have tried to answer below some of the most frequently asked general questions on the topic.

I In the absence of specific contractual provisions, if a party is unable to perform its obligations as a result of the current situation and restrictions imposed by governmental authorities, could that party be deemed to be in breach of contract and be liable for such breach?

According to Article 1218 of the Italian Civil Code (*Liability of the obliged party*), "*An obliged party who does not exactly perform the obligation due is liable for damages, unless he proves that* ***the non-performance or delay was due to impossibility of performance for a cause not attributable to it.***" Moreover, according to the first paragraph of Article 1256 of the Italian Civil Code (*Definitive impossibility and temporary impossibility*), "*An obligation is* ***extinguished*** *when its performance becomes impossible for a cause not attributable to the obliged party.*"

The obliged party may therefore be exempted from liability for non-performance of its obligations or delay in the performance if it proves the impossibility of such performance, and that such impossibility is not attributable to it.

The requirement of impossibility **does not apply**, however, if the event giving rise to the impossibility was foreseeable when the obligation was undertaken, or if the obliged party has not attempted all the remedies aimed at avoiding or overcoming the impossibility. In other words, in order to exclude the liability, the impossibility must be **objective, unforeseeable, absolute** and **insurmountable.**

Possible scenarios of impossibility relevant for this kind of exemption from contractual liability include so-called "***factum principis***", *i.e.* the order or measure adopted by an administrative authority after the obligation was originally undertaken and which renders its performance impossible.

II If the performance of a party has become impossible as a result of governmental measures, what are the remedies offered by the legal system in favour of that party?

In case of definitive impossibility of performance not attributable to the obliged party, **the obligation is extinguished**, without any possible liability on such party for non-performance.

Considering the measures adopted by the Italian government to deal with the coronavirus emergency, cancellation of flights is one of the most obvious cases of definitive impossibility of performance. In such cases, in accordance with the provisions of Article 1256, first paragraph, of the Italian Civil Code: (a) the airline will not be liable for its failure to perform its obligations (Article 1218 of the Italian Civil Code); (b) the contractual obligation assumed by the airline is extinguished; (c) the contract of carriage is automatically terminated by operation of law, without the need for any action on the part of the parties involved. As a result of the termination of the contract, the party released from its obligation may not seek the other party's performance and, if it has already received some benefit from that other party , **it must return it.** So, for cancelled flights, the airline will have to refund amounts paid for the tickets.

Legislative Decree n. 9 of 2 March 2020 dealing with "*urgent support measures for families, workers and businesses connected to the COVID19 epidemiological emergency*" introduced a specific provision for transport contracts (air, rail, sea). Article 28 of that Decree dealing with "*reimbursement of travel tickets and tourist packages*" allows, among other things, for reimbursement of the price paid for a ticket or the issue of a voucher for the same amount valid for one year.

The reimbursement regime under Article 28 mentioned above has now also been extended to contracts for lodging, such as with hotels or for other similar types of accommodation, and which have become impossible to perform owing to the imposition of the restrictive measures by the government. The extension was made under the so-called "*CuraItalia*" Decree of 17 March 2020 on "*measures for the strengthening of the national health service and for economic assistance for businesses, worker and families connected to the COVID19 epidemiological* *emergency*", which was published in the Official Journal on 18 March 2020 (the "**CuraItalia Decree**").

So-called **impossibility to use the service** is also relevant in the air transport scenario, taking account of relevant caselaw. Such impossibility, which is also ground for termination of the contract, arises when the performance described in the contract is still ostensibly practicable, but it can no longer achieve the aim the parties intended by entering into the contract. An example might be where a couple foregoes a booked trip for fear of exposing themselves to infection, notwithstanding there is nothing prohibiting such trip. Although there are no measures adopted by the authorities to prevent the couple from leaving for the trip, their concern of exposing themselves to possible infection could in any event justify their decision not to travel, considering also that the purpose which had led the couple to purchase their airline tickets (*i.e.* to spend a carefree holiday) would be substantially frustrated. In other words, the situation which arises would make it impossible to achieve the essential purpose of the contract, with the consequent extinction of the obligation.

A similar remedy to the one described above, is recourse to the so-called **presupposition**, i.e. a non-codified norm that arises from a specific factual situation that both parties have envisaged, although without mentioning it explicitly, as a fundamental prerequisite of their contractual relationship. An example would be that of an engaged couple who have contracted with a catering company for their wedding day. Even if the marriage were scheduled for a time not covered by the emergency measures adopted by the authorities (*i.e.* the prohibition on civil and religious services and on large gatherings), the state of uncertainty that has arisen in relation to the actual possibility of celebrating the marriage and the likelihood that many of the invited guests would not attend, as well as the absence of an essential premise of the ceremony (*i.e.* a moment of celebration and conviviality with relatives and friends), could allow the couple to seek termination of the catering contract and the return of any payments already made.

The instances described so far concern cases of definitive impossibility. However, it might be that the **impossibility** to perform the obligation is only **temporary**, i.e. as long as the current situation continues (*e.g.* until the removal of certain restrictions aimed at containing the spread of the virus). In relation to such cases, the Italian Civil Code provides, under the second paragraph of Article 1256, that "*if the impossibility is only temporary, the obliged party is not liable for any delay in performance for so long as the impossibility lasts. However, the obligation is extinguished if the impossibility lasts until such time as, in relation to the kind of obligation or the nature of its object, the obliged party can no longer be deemed liable to perform or the beneficiary no longer has an interest in its performance.*" Therefore, in case of temporary impossibility, the obligation is **suspended** without the obliged party being liable for the delay. However, the obligation is nevertheless then **extinguished**, as in the case of definitive impossibility, if such situation continues to such a point that, in relation to the kind of obligation or the nature of its object, the debtor can no longer be deemed to be bound to perform it or the beneficiary is no longer interested in its performance. It will not necessarily be possible to work out in advance whether an impossibility is definitive or temporary; each case will depend on its facts, and the nature and subject matter of the contract, as well as considering the aim pursued by the parties.

In the current situation, an example of temporary impossibility of performance could be that of a seller who, upon temporary closure of his business ordered by the authorities, is unable to deliver goods purchased by a customer. If the deadline for the delivery of the goods is not "essential" and the customer still has an interest in receiving them, the trader cannot be held liable for the delay in delivery for so long as the order to close his business remains in force. In such cases, therefore, the contractual relationship is in a state of "inactivity", which could then be superseded if performance is no longer impossible, or - if, for instance, the customer's interest in the performance of the obligation ceases to exist because the goods purchased were necessary within a certain period of time - the definitive impossibility to perform the service and the consequent termination of the contractual relationship.

Note that, in light of the obvious difficulties that the current health emergency can give rise to for the due performance of existing contracts, Article 91 of the CuraItalia Decree has added to Article 3 of Legislative Decree no. 6 of 23 February 2020 an additional paragraph 6*bis*, that perhaps did not require stating, clarifying that "*compliance with the provisions of this Decree will be taken into account in establishing exemption from liability of the obliged party for the purposes and within the meaning of Articles 1218 and 1233 of the Civil Code, including as regards the application of any forfeiture or penalties related to late or non-performance*".

All the above does not alter the general Italian legal principle by which a party that has not received the corresponding performance due to it can suspend its own performance relying on the non-performance exception under Article 1460 of the Civil Code. The relevant jurisprudence states that the nonperformance exception "*disregards the liability of the counterparty*" and can be claimed also when "*the non-performance of the obligation arises from the related supervening impossibility not attributable to the obliged party*".

III Should one party resort to the above remedies and consequently claim for termination of the contract or for the suspension of performance of its obligation, what are the protections offered by the legal system in favour of the other party?

Article 1463 of the Italian Civil Code (*Total impossibility*) provides that "*In contracts with reciprocal obligations, the party released due to supervening impossibility of the performance owed cannot demand counter performance by the other party and must return what it has already received, in accordance with the rules concerning a claim for return of undue payment*." Therefore, in contracts with reciprocal consideration, impossibility of performance by one party leads to the release of the other party, who will also be entitled to restitution of what it has already paid to the other party for the latter's obligation which has become impossible.

Should the performance of a party become only **partially impossible**, then Article 1464 of the Italian Civil Code (*Partial impossibility*) provides that "*the other party has a right to a corresponding reduction of the performance due by him, and he can also withdraw from the contract if he lacks an appreciable interest in partial performance*". Therefore, in case of partial impossibility of performance, the beneficiary of the performance may seek, alternatively, **the reduction of its own counter performance**, where possible, **or withdrawal** from the contract if it has no interest in obtaining the partial performance. On the other hand, the party whose performance has become partially impossible will remain obliged to continue to perform those of its obligations which are still possible.

In light of the government measures requiring the closure of many commercial activities, a particular example of temporary and partial impossibility of performance relates to commercial lease contracts affected by the restrictive measures.

In such cases, even if the property is, at least theoretically, in usable condition, and even if the tenant could use it, the tenant obviously cannot enjoy it for so long as there is a prohibition on carrying out the activity for which the property was leased. As for all contracts with continuous and periodic performance (including leases), the temporary impossibility could therefore equate to a partial impossibility, with the consequence that the tenant who has no wish to withdraw from the lease (trusting in a recovery of his business), or cannot (e.g. because it excludes withdrawal for serious reasons), would be entitled to obtain a "corresponding" suspension or reduction of the rent. Such reduction should correspond to the period of non-use of the property.

In light of the foreseeable "*negative effects arising from the prevention and containment measures*" connected to the coronavirus emergency, Article 65 of the CuraItalia Decree has granted to all business operators (other than those in special categories of essential services set out in Appendices 1 and 2 of the Decree of the President of the Council of Ministers of 11 March 2011 such as pharmacies, para pharmacies, points of sale of basic foodstuffs etc.), a tax credit for the 2020 year equal to 60% of the lease rent related to March 2020 for buildings falling within cadastral category C/1 (i.e. shops and workshops). The tax credit can be used exclusively by way of offset under Article 17 of Legislative Decree no. 241 of 9 July 1997. It is possible that the grant of this tax credit could therefore be relevant in assessing, in any particular case, whether the circumstances count as supervening excessive onerousness under Article 1467 of the Civil Code or as serious reasons grounding withdrawal under Article 27 paragraph 8 of Law 392/1978.

IV If the performance of a party has not become impossible, but only excessively burdensome compared to how it was when it was undertaken, what remedies are available to that party?

In the context of international commercial contracts, especially those that have a prolonged duration, so-called **hardship** clauses are very common. The purpose of such clauses is to manage any problems that may arise during the performance of the contract that make it more onerous for one of the parties to perform its obligations, albeit not necessarily "excessively" onerous within the meaning of Article 1467 of the Civil Code. Through such clauses, the parties, on a contractual basis, (a) identify the possible circumstances that could arise during the relationship and determine an alteration of the contractual balance; (b) establish the methods for ascertaining the same; and (c) regulate the possible remedies to be applied upon occurrence of one of such circumstances, generally providing for a phase of re-negotiation of the contract aimed at adapting the conditions to the new situation that has arisen, and therefore to restore the contractual balance between the obligations.

In the absence of explicit contractual provisions covering such scenarios, the only remedy that the Italian legislation expressly provides for is that of the so called **supervening excessive onerousness.** In particular, Article 1467 of Italian Civil Code (*Contracts with mutual obligations*), provides that "*In contracts with continuous or periodical performance, or deferred performance, if extraordinary and unforeseeable events make the performance of one of the parties excessively onerous, the party who owes such performance can demand the termination of the contract, with the effects set forth in Article 1458. Termination cannot be demanded if the supervening onerousness falls within the normal risk of the contract. A party against whom termination is demanded can avoid it by offering to modify equitably the conditions of the contract*."

First of all, the remedy of termination of contract due to excessive supervening onerousness is applied only to contracts with continuous or periodical performance, or deferred performance. These are so-called long-term contracts, the effects of which extend over time, with the parties having to perform their obligations continuously (e.g. lease agreements), or at timed intervals (e.g. service supply contracts), or at a time subsequent to the contract's execution (e.g. sale and purchase agreements, if they provide for deferred and/or conditional completion).

Moreover, in order to claim for termination of contract pursuant to Article 1467 of the Italian Civil Code, the excessive onerousness must consist of a **significant alteration** of the contractual mutual obligations, which requires one of the parties to bear a much greater economic sacrifice than the expected risk of the contract. Generally, it is understood that supervening excessive onerousness corresponds to an increase, obligation the time of performance, of the "cost" of such performance compared to what was anticipated when the contract was entered into. Obviously, the increase of the cost of the performance must be such as to significantly alter the balance between the reciprocal obligations that existed when the contract was entered into.

The concept of excessive onerousness of the performance is not further defined in the law. It is generally accepted that it must be analysed on the basis of strictly objective criteria (*i.e.* without making reference to aspects related to the representation of the parties and the organization of the obliged party). Supervening excessive onerousness has to be distinguished from a mere difficulty of a party to perform its obligation, to which the Italian legal system does not attribute any juridical relevance (whether in relation to termination of contract for supervening excessive onerousness, or as justification for failure to perform)

Moreover, the excessive onerousness must result from **extraordinary** (i.e. totally exceptional) and **unforeseeable** events (*i.e*. that the parties, using ordinary diligence, could not have foreseen at the time of the contract was entered into). If, on the contrary, the supervening excessive onerousness falls within the normal risk of the contract, and therefore within the degree of uncertainty typical, natural and implicit for the contract and to which each party submitted by entering into it, then the remedy of termination is excluded. Although, as noted, the notions of extraordinariness and of unforeseeability may be conceptually different, there is obviously a link between them in as much as unforeseeability presupposes the extraordinariness of the event, but not vice versa.

The effects of termination are those provided for in Article 1458 of the Italian Civil Code (*Effects of Termination*), according to which "*Termination of a contract for non-performance has retroactive effect between the parties, exception made for contracts with continuous or periodic performance, with respect to which the effect of termination does not extend to obligations already performed. The termination, even if it has been expressly agreed upon, does not prejudice rights acquired by third parties save for the effects of the transcription of the action for termination.*"

Therefore, the termination of the contract has retroactive effects involving, on the one hand, the release of both parties from the performance of their respective obligations and, on the other hand, the obligation to return and refund the obligations performed and/or received up to the termination.

If the party against whom the termination due to supervening onerousness is claimed wants to avoid the termination of the contract, then it may offer to the other party to amend the conditions of the contract "**equitably**", according to a good faith assessment that balances the contractual relationship between the parties. There are differing views on whether in a procedure for termination of the contract the party who wishes to avoid such termination, must make a specific equitable reduction offer first, or whether it may merely express its availability to make such a reduction. In some cases, the Court of Cassation has acknowledged the possibility of judicial intervention in the revision, for example, of the contractual consideration established by the parties, or in determining the content of the changes to be made to the contract to make it equitable, provided that such initiative has been requested by the party concerned, and in any case only on the basis of matters disclosed during the judicial procedure.

It should be stressed that, unlike in the instances of supervening impossibility of performance (where the obligation is automatically extinguished), in cases of supervening excessive onerousness, the party whose performance becomes excessively onerous will not be automatically exempted from performance, or allowed to suspend it. Rather, in order to be released from its obligation and not incur liability for non-performance, such party will have to take legal action to request the termination of the contract.

Also of note is the fact that, under Article 1468 of the Civil Code, the remedy of termination is not practicable for unilateral contacts with obligations only on one side (such as a noninterest-bearing loan). For these, in claiming supervening excessive onerousness, the obliged party can ask for a reduction of its obligation or a change in the manner of its execution sufficient to make it equitable. Termination of such contracts was excluded from the ambit of the law because, were it allowed, it would be tantamount to releasing the obliged party without any loss of related economic benefit. In such cases, as for those under Article 1467 of the Civil Code, if the parties do not agree, it will be for the judge to determine the reduction in performance or the change in the manner of execution.

Looking at the current situation, an example of supervening excessive onerousness could be that of a supplier of disinfectant whose production costs, due to and in conjunction with the spread of the virus (and the consequent increase in demand), have increased abnormally, and in a way unpredictable at the time the supply contract was entered into.

Apart from cases of excessive onerousness, the Italian Civil Code does not expressly provide for remedies where an imbalance in performance cannot be defined as excessive, even though it becomes more onerous for the party that has to perform it. If there are no specific remedies set out in the contracts, such as, for example, the aforementioned "hardship" clauses, having recourse to the general principles of the legal system and, in particular, to the general requirement of good faith (Articles 1366 and 1375 of the Italian Civil Code) and to the principle of supplementary equity (Article 1374 of the Italian Civil Code), it is in any case possible to argue that there is a right for the party affected to renegotiate the terms of the contract, and, of course, for the other party an obligation, based on the **duty** to act in good faith and fairness in the performance of the contract, to consent to such **renegotiation.**

The obligation to renegotiate, essentially, would entail the duty, in some circumstances, to respond to the invitation to renegotiate by accepting the proposed modifications or proposing solutions which, in keeping with the economics of the contract and taking into account its economic convenience, allow the contractual relationship to be re-balanced. Naturally, failure to reach agreement in such renegotiation could not of itself constitute a breach of the obligation to renegotiate. Breach of the obligation would only occur in cases of an absolute and unjustified refusal to negotiate, as well as in cases where a party only gives a semblance of its willingness to negotiate (so-called malicious renegotiation), without however having any real intention of reconsidering the terms of the agreement.

V Can the force majeure clauses in some commercial contracts be relevant in the context of the current situation?

Generally, force majeure clauses are negotiated on the basis of Anglo-Saxon models and provide that, in case of unforeseeable, extraordinary events not imputable to the obliged party, which result in impossibility of performance, or excessive onerousness of the same, the party may suspend the performance, terminate the contract or require equitable changes to the terms of the contract.

Generally, such clauses provide for a broad definition of force majeure, followed by an indicative list of circumstances deemed to be force majeure. Therefore, depending on the specific wording of the force majeure clause, the current circumstances (for example, the World Health Organization's declaration of a pandemic) may have a specific contractual relevance and may allow the suspension of performance of the obligation or other possible consequences envisaged in the relevant clause.

Given that, as stated above, force majeure implies the occurrence of an unpredictable and unavoidable event, the current situation related to the outbreak of the coronavirus can only be relevant for contracts entered into before the outbreak. For contracts entered into, amended or renegotiated more recently, specific clauses aimed at regulating any supervening difficulty or possible obstacles to the performance of the agreement arising from the current situation will have to be specifically agreed.

VI What about "*material adverse change*" clauses?

So-called "MAC" clauses, *i.e.* "material adverse change" clauses, are provisions frequently used in sale and purchase agreements, in particular in cases where the execution of the sale is significantly deferred in time and/or in cases where the buyer is using acquisition financing and the loan agreement includes a MAC clause, in order to align the two agreements.

In general, a MAC clause provides for the right of the buyer to withdraw from the contract or to request a review of the price if, after signature of the agreement, but before the execution of the sale (*closing*), a so-called "material adverse change" occurs, i.e. an unforeseeable and extraordinary event, act, fact or circumstance, not imputable to the parties, that significantly impacts on the value of the target or on some economic/financial indicators identified by the parties. MAC clauses, unlike force majeure or hardship clauses (the latter, as already noted, arising mostly in long-term contracts), are aimed less at dealing with the consequences of future unforeseeable events that might arise during the term of the contract and disturb its balance, and more at the prejudicial effects of circumstances that might arise between signing of a purchase agreement and its closing (such as related to breaches by a seller of interim management undertakings it has given to the buyer). In some cases, non-occurrence of the events provided under the MAC clause up to the closing date is a condition precedent - usually in the sole interest of the buyer who, therefore, is the only party who can waive it - to the parties' obligations to perform closing.

Depending on how a particular MAC clause is phrased, the consequences of the COVID-19 situation could potentially trigger the remedies provided under it.

VII What are the economic/financial indicators relevant for material adverse change that are usually provided for in MAC clauses? What order of magnitude is necessary to invoke the clause?

The economic/financial elements that are usually relevant in MAC clauses include EBITDA, turnover, production capacity, profitability, operations, net financial position, etc. The MAC clause would, therefore, only operate in the event that the occurrence of the relevant material adverse event has a significant impact on one or more of the stated indicators.

Sometimes, the definition of material adverse change is broad and generic, but then provides for certain exceptions, in order to limit the relevance of the clause to those events that have a specific impact on the target and excluding those events that would impact on the capital markets in general, on the macroeconomic situation in general or on the broader sector in which the target company operates, as well as, in some cases, also excluding the effects of legislative or regulatory changes that may occur during the contract.

It is also common to provide for thresholds of materiality with respect to the impact that the occurrence of the adverse event may have on the stated indicators. This is to overcome the interpretative problem that the concept of "materiality" of the relevant adverse effect would present in the absence of a specific indication by the parties.

For further information, please reach out to your usual Chiomenti contact.

Contacts

Luca Ferrari
Partner – Chiomenti
Litigation and Arbitration Department
T. +39 02 72157 304
luca.ferrari@chiomenti.net

Luca Liistro
Partner – Chiomenti
Corporate Department
T. +39 02 72157 322
luca.liistro@chiomenti.net

Silvio Martuccelli
Partner – Chiomenti
Litigation and Arbitration Department
T. +39 02 72157 302
silvio.martuccelli@chiomenti.net

Arnaldo Cremona
Senior Associate – Chiomenti
Corporate Department
T. +39 02 72157 323
arnaldo.cremona@chiomenti.net