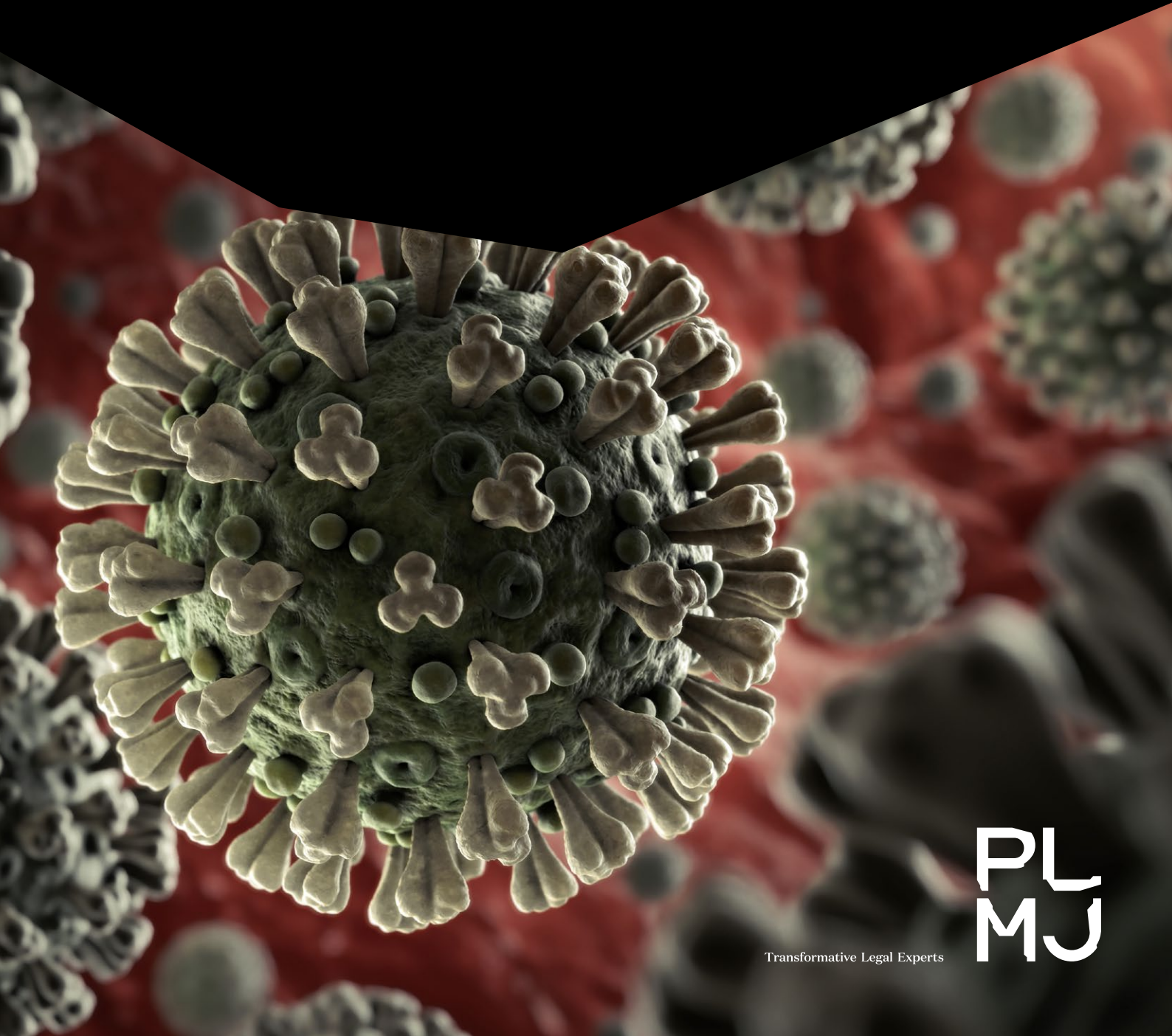


Coronavirus

International contracts

Impossibility, change of
circumstances, contractual provisions
and investment arbitration



Transformative Legal Experts

PL
MJ

Contents

1	Impossibility	04	3	Contractual provisions	27
	Germany	04		Force majeure clause	27
	Angola	06		Hardship clause	29
	Brazil	06		Material adverse change clause	30
	China	07			
	Spain	08	4	Investment arbitration	32
	France	09		Mechanisms provided for in BITs	32
	United Kingdom	10		Mechanisms of international law	34
	Italy	11		Concluding remarks	37
	Switzerland	12			
	International legal instruments	14			
2	Change of circumstances	16			
	Germany	16			
	Angola	18			
	Brazil	18			
	China	19			
	Spain	19			
	France	21			
	United Kingdom	22			
	Italy	22			
	Switzerland	23			
	International legal instruments	24			

Introductory Note

On 11 March 2020 the World Health Organization declared the existence of a pandemic. The main focus was to guarantee the safety of workers and employees. However, the potential repercussions for the activities of companies – in the short and medium term – are vast, complex and, in certain cases, conflicting.

In particular, measures taken around the world to combat the spread of COVID-19 may make it more difficult or even impossible to perform certain contracts. The uncertainty caused in contract management is accentuated in international contracts, in which the policies adopted in the various countries where the contract is to be performed will have to be taken into account.

Besides the new rules that apply, the parties may have negotiated a force majeure or hardship clause providing for the effects of an unforeseeable and uncontrollable supervening event that makes performance of obligations impossible or unenforceable. “Material adverse change” clauses are commonly used in the specific fields of acquisition of shareholdings and of loan agreements. In such cases, the parties are bound by the contractual arrangements. However, it may be that the force majeure or hardship clauses do not cover an impediment caused by the new Coronavirus, that problems of interpretation arise¹ or that not all aspects of the situation are governed by the contract. In such cases, the parties will have to turn to the substantive law applicable to the contract on a supplementary basis.

In addition to national laws and contractual arrangements, there are international instruments such as the United Nations Convention on Contracts for the International Sale of Goods (CISG) or the *lex mercatoria* (e.g., general principles of international law or the UNIDROIT Principles of International Commercial Contracts²).

Given the breadth of the topic, this Newsletter has been divided into 6 parts, in which the legal instruments provided for by the laws of different legal systems are explained in general terms:

- An inevitable and uncontrollable event that makes it impossible for the parties to perform the obligations they have undertaken – a question that will be dealt with in **part 1** under the heading of “impossibility”;
- An inevitable and uncontrollable event which, although it does not make performance impossible, fundamentally unbalances the assumptions of contractual equilibrium on which the parties based their decision to contract – a matter which will be dealt with in **parts 2** under the heading “change of circumstances”.

These four parts will address the rules of the following jurisdictions: Angolan, Brazilian, Chinese, English, French, German, Italian, Spanish and Swiss. Finally, the solution of the United Nations Convention on Contracts for the International Sale of Goods (CISG)³, the UNIDROIT Principles of International Commercial Contracts (PICC)⁴ and the Principles of European Contract Law (PECL)⁵ will be presented.

The contractual mechanisms commonly provided for by the parties in this area will then be examined in **part 3**: the force majeure clause; the hardship or change of circumstances clause; and the material adverse change clause.

The last part of this newsletter, **part 4**, is devoted to the impact of COVID-19 on investment arbitration.

¹ In the ICC (International Chamber of Commerce) case no. 11265 (2009), ICC International Court of Arbitration Bulletin, vol. 20 no. 2, the contract did not explicitly define the concept of force majeure, but referred to a list of facts which it classified as force majeure. The arbitral tribunal then held that the force majeure provision in the contract should be read in the light of the UNIDROIT Principles, which contain a comprehensive definition of the concept of force majeure.

² Moses, Margaret, *The Principles and Practice of International Commercial Arbitration* (Cambridge University Press, 3rd edition, 2017) p. 78.

³ This Convention harmonised the law applicable to international sales contracts and became a point of reference for lawyers and researchers in the area of comparative law. It currently has 93 contracting parties around the world, from all legal and economic systems. It applies not only when the parties expressly provide for its application, but also when the applicable law (chosen by the parties or resulting from conflict rules) is that of a State that signed the Convention or where both parties are resident in one of those States and have not decided which law is applicable (see article 1(f) of the CISG). On 16 July 2020, the Portuguese Council of Ministers approved a decree, signed on 23 July, for Portugal's accession to the CISG – on this, see PLMJ's Informative Note “[Portugal joins the 1980 Vienna Convention on Contracts for the International Sale of Goods](#)”.

⁴ The Principles of International Commercial Contracts (PICC) are a soft law instrument, produced by UNIDROIT, which are intended to harmonise the law applicable to international commercial contracts. The PICC apply to the contract if the laws so agree, or when the applicable law is the general principles of law or the *lex mercatoria*. The PICC will also be used to interpret or supplement instruments of international or national law and are intended to serve as a model to be used by national or international legislators (see Preamble to the PICCs).

⁵ The Principles of European Contract Law (PECL), like the PICC, are a soft law instrument. However, unlike the PICC, they also apply to purely domestic contracts and consumer contracts, and their geographical scope of application is restricted to the European Union.

1. Impossibility

The vast majority of national legislations have laid down the rules applicable in the event that performance becomes impossible. There are countries, such as Germany and Italy, where the law expressly states that the affected party has no obligation to comply. However, the legal provisions of most jurisdictions only indicate that the debtor is not liable for the damage caused by non-compliance as long as the impediment remains, assuming that the debtor does not have to comply with an impossible obligation. Moreover, as a rule, if the breach is definitive, the contract may be terminated. Exceptionally, in the United Kingdom, the impossibility does not exonerate the debtor affected, although the doctrine of “frustration” ultimately remedies that position.

Most of the legal systems examined define impossibility by reference to an unforeseeable, inevitable and irresistible fact.

Impossibility is thus defined in absolute terms. This means the debtor affected by it is obliged to perform, even if this involves considerable efforts that it had not initially foreseen. Exceptionally, in Germany, the law provides that the debtor is released from a non-monetary obligation if the expenditure and efforts are disproportionate in face of the interest of the creditor. This criterion of reasonableness is reflected in the international instruments PICC and PECL, both in the definition of impossibility and in the exclusion of the right to specific enforcement (articles 7.2.2(b) of the PICC, art. 9:102 of the PECL).

Furthermore, according to the objective definition of most of the national legal systems analysed, the debtor is obliged to turn to third parties if they can provide the service in its place. This understanding is also enshrined in the international instruments CISG, PICC and PECL.

In the following paragraphs, we will analyse the requirements of impossibility and their consequences in each legal system.

According to the objective definition of most of the national legal systems analysed, the debtor is obliged to turn to third parties if they can provide the service in its place.

Germany

The German Civil Code (Bürgerliches Gesetzbuch, or “BGB”) provides that performance of obligations is excused when it is impossible for the debtor or for any other person. Absolute impossibility refers to a legal or natural impediment that the debtor cannot overcome by any means. Thus, for example, the contractor will be absolutely prevented from complying if and for as long as the State of the country in which the work is carried out orders the compulsory suspension of any construction activity.

As a general rule, the affected party must overcome the consequences of the impediment by taking all necessary steps to perform its obligations, either by alternative means or through an agreed replacement performance, even if this entails additional costs or a substantial loss⁶.

⁶ Can Aksoy, Hüseyin, *Impossibility in Modern Private Law: A Comparative Study of German, Swiss and Turkish Laws and the Unification Instruments of Private Law* (Springer, 2013) p. 105.

However, a limit is introduced on the efforts that are required from the debtor affected. Thus, the rules on impossibility also apply when, even if compliance is not absolutely impossible, it entails extraordinarily high sacrifices disproportionate to the creditor's low interest in the performance (practical impossibility). A cost-benefit analysis is required, the weighting of which must take into account the object of the obligation, the principle of good faith and the debtor's responsibility in creating the obstacle⁷. The classic example of practical impossibility is that of a ring that the debtor was obliged to hand over. The ring was worth 100 euros and it fell into a river. Although it was not impossible to drain the river to recover the ring, drainage would have cost much more than the value of the ring⁸. As a rule, practical impossibility covers only non-pecuniary obligations and it excludes situations where market prices change, with the consequence that performance becomes more costly. In other words, it does not cover "economic impossibility"⁹. In any event, this situation could be covered by the institute of change of circumstances.

In the event of any of the above, the affected party will be released from the obligation to perform, temporarily or definitively, depending on the nature of the impeding event. However, the debtor may be required to reimburse the expenses¹⁰. If the creditor has not contributed to the impossibility of performance, it is no longer obliged to provide the consideration and may terminate the contract¹¹.

7 DiMatteo, Larry, "Contractual excuse under the CISG: impediment, hardship, and the excuse doctrines", 27 (2015) *Pace International Law Review*, p. 264.

8 Brunner, Christoph, "Force Majeure and Hardship under General Contract Principles: exemption for Non-Performance" in *International Arbitration*, Kluwer Law International, p. 83.

9 Hondius, Ewoud e Grigoleit, Christoph, *Unexpected Circumstances in European Contract Law* (Cambridge University Press, 2011), p. 58.

10 See paragraph 284 of the BGB.

11 See paragraph 326 of the BGB.

The Brazilian Civil Code states that “the debtor will not be liable for any losses resulting from unforeseeable circumstances or force majeure, if there is no express liability for them”.

The German courts have already ruled on what is an impossible fact in the context of a health crisis. They have made reference to a force majeure clause, which case law classifies as an external fact that cannot be avoided even with the use of all the care that can reasonably be required of the debtor. In the context of passenger cancelling their flight, the Augsburg District Court classified the SARS epidemic, which broke out in 2003, as a case of force majeure. The court held that, with considerable probability, it could cause unreasonable risks to the life and health of the passenger¹². The German courts have also classified administrative orders such as embargoes and production restrictions as force majeure events¹³.

Angola

Under the terms of Ministerial Order 22869 of 4 September 1967, issued by the Overseas Ministry (Directorate-General for Justice), the effectiveness of the Portuguese Civil Code was extended to Angola, as approved by DL 47344 of 25 November 1966. Although this Code has undergone its own amendments in Angola, the rules on impossibility of compliance remain unchanged. We therefore refer to what we have already written on the management of the risk of breach of contract under the Portuguese rules, particularly regarding the rules on definitive and temporary impossibility¹⁴. With regard to bank credits, while the State of Emergency was in force, that is, from 27 March to 25 May 2020, default notices, default situations and enforcement actions arising from a delay in complying with obligations that could not be performed as a result of the application of government measures taken to combat the epidemic remained ineffective¹⁵.

Brazil

The Brazilian Civil Code states that “the debtor will not be liable for any losses resulting from unforeseeable circumstances or force majeure, if there is no express liability for them. A fortuitous or force majeure event occurs in the necessary fact, the effects of which could not be avoided or prevented” (article 393).

Force majeure must be inevitable, as must its effects. Thus, it is not enough for the fact to affect the debtor’s ability to comply personally. Instead, it is necessary that the debtor (i) cannot replace itself (e.g., a transporter living in a town covered by a cordon sanitaire may be replaced by a transporter not covered by the cordon), or that (ii) it cannot use an alternative service (e.g., in the case of the sale of fungible goods which have perished, it may have to buy goods from another supplier). It does not matter whether performance becomes more difficult or more expensive. It is also indispensable that the obstacle is outside the domain of the party affected, and that it results from a natural event or the action of a third party¹⁶. The letter of the law makes no reference to the unforeseeability of the fact, and doctrine is not consensual as to whether or not such a requirement is necessary¹⁷.

¹² Judgment of 09.11.2004 of the District Court of Augsburg, P. no. 14 C 4608/03.

¹³ Judgment of 16.09.2004 of the Frankfurt am Main High Court, P. no. 16 U 49/04.

¹⁴ PLMJ (Morais Antunes, João Tiago, Figueiredo, André e Schmidt Lino, Duarte (coord.)), “Coronavirus: Managing the risk of breach of contract”, available [here](#).

¹⁵ This rule was implemented by Presidential Decree 82/20 of 26 March, which regulated the State of Emergency. Currently, the country subject to a state of calamity. See Presidential Decree no. 229/20, of 8 September.

¹⁶ Silva Pereira, Caio Mário da, *Instituições de Direito Civil: Teoria Geral das Obrigações* (Forense, 2014), p. 277.

¹⁷ Ibid.

When a force majeure event occurs, if the party affected has not assumed the risk of its occurrence by contractual means, it is not liable for the losses resulting from the non-performance. However, if the impediment is merely temporary, performance of the obligation is only suspended. If the non-performance, whether definitive, temporary or partial, seriously affects the purpose and object of the contract, this contract may be terminated, with effect from the occurrence of the fact. In cases of partial impossibility, the debtor who accepts the performance is entitled to have its consideration reduced in proportion¹⁸.

As to what the Brazilian courts may hold to be impossible performance in the context of the current health crisis, it can only be said that case law is demanding as to proof of the causal link between the fact (in this case, the epidemic itself or the measures taken to combat its spread) and the impediment. It requires that the fact cause an absolute impossibility to perform, and not only a greater economic difficulty in doing so. According to the Brazilian Supreme Court of Justice, “any failure of the enterprise or financial difficulties are inexorably covered by the risk inherent to any business activity and cannot be considered an external fortuitous event (force majeure)”¹⁹.

China

Under articles 180 of the General Provisions of Civil Law and 117 of the Contract Law of the People’s Republic of China, any party that is unable to fulfil their obligation because of force majeure cannot be held civilly liable. The parties may also terminate the contract if, by reason of force majeure, its purpose is frustrated (article 94(1) of the Contract Law).

An event of force majeure is any objective circumstance that comes after the conclusion of the contract and which is unforeseeable, inevitable and insurmountable. It is for the party affected to claim and prove that the above requirements have been met and to demonstrate the existence of a direct causal link between the event and the impossibility of compliance.

The Chinese courts have the power to declare, with binding force, whether or not a fact is classified as force majeure. In 2003, on the occasion of the SARS outbreak, the Supreme Court of China published a judicial interpretation that, if contractual obligations could not be fulfilled due to administrative decisions taken by the government and ministerial departments to prevent the spread of the epidemic or due to its impact, the courts should apply the rules of force majeure. In fact, in 2005, the Intermediate People’s Court of Sanya held that the administrative order, decreed by the Sanya City Government during the SARS period, which prevented construction companies from employing emigrant workers, was the reason why the contractor had not recruited enough staff to conclude the construction contracts entered into before the administrative order. Consequently, the party affected was relieved of liability for the delay and breach of its obligations under the contracts in question²⁰.

The Chinese courts
have the power to
declare, with binding
force, whether or not
a fact is classified
as force majeure.

In relation to COVID-19, the Supreme Court of China published a guiding opinion on 16 April 2020. This opinion confirmed that the institute of force majeure should be applied in the current context and that the courts should assess the impact of the epidemic according to the region, industry, and circumstances of the case, in order to assess the necessary causality between the fact and the impossibility. The opinion stresses that if the epidemic or the measures taken to curb it only cause greater difficulty in performing the contract, the parties should be encouraged to renegotiate the contract and may not terminate it. Furthermore, the court should take into account the fact that one of the parties has benefited from government subsidies, tax relief or other types of grant.

18 Oliveira Martins, Lucas Gaspar de, *Contornos de inadimplemento absoluto, da mora e do adimplemento substancial: principais características e distinções*: mestrado em direito (Pontifícia Universidade Católica de São Paulo, 2008), p. 106.

19 Judgment of 6 November 2017 of the Brazilian Supreme Court of Justice, Special Appeal, P. no. 1,341,605/PR.

20 Judgment of 2005, Sanya Intermediate People’s Court, Sanya Min Yi Zhong Zi no. 79.



Spain

Article 1105 of the Spanish Civil Code states that “Outside of the cases expressly stated by law and in those in which the obligation so declares, no one will be liable for those events that could not have been foreseen or that, being foreseen, were unavoidable”. The article does not expressly define the concepts of force majeure or fortuitous events, but refers to the characteristics that doctrine associates with them.

The courts classify an event of force majeure as an “event which is unforeseeable or which, when foreseen, is inevitable, insurmountable or irresistible, because it goes beyond the normal course of life; which is not due to the action of the alleged debtor; and that there is a connection or causal relationship between the fact and the result”.²¹

The courts have required that this event must occur after the contract has been made, and that it render useless any diligent action on the part of the debtor to perform it²². The affected party is required to take all steps necessary to mitigate its harmful effects and to always act in good faith.

All the objective circumstances of the case, as well as those concerning the debtor itself (its resources and ability to foresee and react to the unforeseeable event) must therefore be analysed. Consideration must also be given to the distribution of the risk arising from the contract.

The party affected by a force majeure event will be exonerated from liability for any loss or damage caused by non-performance for as long as and to the extent that it persists. This means that the creditor is not entitled to demand performance²³.

Force majeure may give rise to definitive breach (even in cases of temporary impossibility, if the creditor loses interest in the performance). This entitles the creditor to terminate the contract²⁴.

21 Judgment of the Spanish Supreme Court, 17.05.1983, cited by Catalá, Raquel Poquet, “Los últimos perfiles de la fuerza mayor como causa extintiva”, 2 (2015) IUSLabor, p. 4.

22 Judgment of the Spanish Supreme Court, 18.12.2006, Extraordinary Appeal no. 200/2000.

23 This conclusion would already result from article 1182 of the Spanish Civil Code.

24 Under article 1124 of the Spanish Civil Code.

In the past, the Madrid Provincial Court ruled on a contract in which a travel agency booked air tickets on a flight to Toronto²⁵. That city had, in the meantime, been put on alert by the spread of SARS. Although the airline did not cancel the flight, the court found that the travel agent was no longer obliged to purchase the tickets and could demand that the deposit paid in the meantime be returned to it without any penalty. The court held that SARS was an unforeseeable and insurmountable event and that. It also held that, although it was not physically impossible to travel to Toronto, the rationale for any person of average diligence was to heed the recommendations of the authorities and not to endanger life or health by travelling imprudently to a place subject to a health alert.

The Madrid Provincial Court also held that a company responsible for a cruise trip could not be held liable for the damage caused by the spread of the type A flu virus. This was a force majeure event, as the doctor and the captain of the ship were neither aware nor in a position to know that there were crew members who were carriers of the disease, considering that the situation that arose was unpredictable and inevitable²⁶.

These guidelines may be relevant to COVID-19, although the actual effect of the epidemic on the performance of the obligations and the moment when the obligation was established should always be analysed.

France

The French Civil Code enshrines the institution of force majeure in article 1218. Under this article, according to which “*There is force majeure in matters relating to a contract when an event beyond the control of the debtor, which could not reasonably have been foreseen at the time the contract is signed and the effects of which cannot be avoided by appropriate measures, prevents performance of the obligation by the debtor*”.

For a fact to constitute force majeure, three requirements must be met: (i) the fact is external and uncontrollable; (ii) the fact was not reasonably foreseeable; (iii) the fact effectively renders performance impossible (absolute impossibility), which is not to be confused with making the obligation more onerous or costly.

These guidelines may be relevant to COVID-19, although the actual effect of the epidemic on the performance of the obligations and the moment when the obligation was established should always be analysed.

Consequently, there can be no other ways of fulfilling the obligation, for example by using alternative suppliers, materials or staff. In addition, it would be difficult to say that force majeure can relate to pecuniary obligations²⁷.

If the force majeure event is temporary, the obligations affected are merely suspended (unless the creditor loses interest definitively, which leads to the termination of the contract)²⁸. On the other hand, if the force majeure event is permanent, the breach is considered definitive. Then, the contract may be terminated and the parties are released from their obligations²⁹. In either case, the party that fails to fulfil its obligation, or does not fulfil it in time, does not have to compensate the creditor for the damage caused³⁰.

25 Judgment of the Madrid Provincial Court, 2.11.2006, appeal no. 358/2006.

26 Judgment of the Madrid Provincial Court, 10.12.2013, appeal no. 145/2012, cited by Sáez, Óscar Santaella, “La responsabilidad patrimonial de la Administraciones Públicas en la gestión del Coronavirus”, available [here](#).

27 For example, judgment of 16.09.2014 of the Court of Cassation (France), Commercial Chamber, P. no. 13-20.306.

28 Under article 1218 of the French Civil Code.

29 With rare exceptions, under article 1351 of the French Civil Code.

30 See article 1231(1) of the French Civil Code.

The French courts have been demanding the classification of an epidemic as a force majeure event. During the type A flu epidemic, the cour d'appel de Besançon³¹ held that the legal imposition of the use of disposable sanitary products did not make it possible to terminate a contract for the supply of cloth hand towels, because it was possible for the debtor to supply disposable towels. Furthermore, the court held that this was not sufficiently unforeseeable, because the epidemic had been widely announced and anticipated, even before the application of the health regulations.

As regards the need for there to be a causal link between the impediment and the impossibility of complying with the obligations, the cour d'appel de Paris³² held that the severity of the Ebola epidemic that struck West Africa, even if it could be regarded as a case of force majeure, was not sufficient to establish that that epidemic affected the cash flow of a company based there.

The United Kingdom has traditionally been very demanding in respect of the prevalence of situations of force majeure as a justification for breach of contract.

The Paris Court of Appeal³³ has already dismissed a claim for reimbursement for a trip to Thailand whose booking was cancelled because of the SARS epidemic. In this case, there were no restrictions on the flight or on the entry of passengers into the territory. Only medical checks were imposed at the time of entry and masks had to be worn. Furthermore, there was no risk of catching the virus in Thailand at the time of travel, because there were no instances of transmission of the virus in Thailand.

In France, decisions have already been taken on COVID-19 that have classified the impediments it has generated as force majeure. These include the cancellation of flights by the Italian authorities³⁴ and prison detention in an establishment with positive cases which made it impossible to appear before the court³⁵. However, it cannot be assumed that this will be the approach taken in all cases. An analysis of the cases shows that the French courts always examine all the specific details of the case.

United Kingdom

The United Kingdom has traditionally been very demanding in respect of the prevalence of situations of force majeure as a justification for breach of contract. In principle, the affected party will have to perform and will have to compensate the other party for the damage caused if it fails to do so. The leading case (*Paradine v Jane*) concerns a tenant who was ordered to pay the rent even though he had been evicted and prevented from being in possession by an army.

However, the doctrine of frustration makes this understanding more flexible by allowing the contract to end automatically. A contract can be frustrated when a later event occurs that is not attributable to either party, which makes the nature of the obligation radically different from the one originally assumed, and which definitively goes beyond what was contemplated by the parties when they entered into the contract. The courts are very demanding in applying this doctrine and it is not sufficient that performance simply becomes more difficult or more costly. Frustration operates automatically, without the party having to inform the other party of the fact.

31 Judgment of 08.01.2014 of the Besançon Judicial Court, second commercial chamber, P. no. 12/02291.

32 Judgment of 17.03.2016 of the Court of Appeal of Paris, Pole 6, room 12, P. no. 15/04263.

33 Judgment of 29.06.2006 of the Court of Appeal of Paris, Section 8, Section A, P. no. 04/09052.

34 See, for example, judgment of 04.03.2020 of the Court of Appeal of Douai, P. no. 20/00395 and judgments of 05.03.2020, P. no. 20/00400 and 20/00401, of the same court.

35 For example, judgment of 12.03.2020 of the Court of Appeal of Colmar, P. no. 20/01098.

The doctrine was established in the case of *Taylor v Caldwell* (1863) 3 B&S 826. This case concerned a contract for the lease of a concert hall that was destroyed by fire before the first concert. The court found that the parties had set out all the details of the programme and of the venue, and stated that the preservation of the venue was an essential condition for the parties. As a result, it concluded that the occurrence of the fire brought the contract to an end.

The courts have applied the doctrine of frustration when events occur that make the performance of the contract unlawful. The doctrine was applied, for example, in the *Fibrosa v Fairbairn* (1943) AC 32 case. This case involved a supply contract for machinery between an English and a Polish company. After the contract had been signed and the buyer had paid the deposit, Germany invaded Poland and declared the supply contracts between the two countries illegal. However, in a recent 2019 case, *Canary Wharf (BP4) T1 Limited & others v European Medicines Agency* (2019) EWHC 335 (Ch), the court found that Brexit did not frustrate a 25 year lease for the space in which the European Medicines Agency was established. The key argument may have been based on the criterion of foreseeability. The court held that, although Brexit itself was not foreseeable, it was foreseeable that the European Medicines Agency would have to leave the space before the end of 25 years because of circumstances beyond its control. It should therefore have included a divestiture/break clause in the contract, and by not doing so, it had assumed that risk.

Frustration was enshrined in law by the Law Reform (Frustrated Contracts) Act 1943 (LRA), which applies to various commercial contracts, and which provides as a general principle that (i) the amount paid before the frustrating event occurred must be returned to the other party; (ii) the amount due, but not yet paid, ceases to be due; (iii) the party who, before the frustrating event occurred, obtained a non-monetary benefit on account of the contract, may have to compensate the other party.

Italy

The Italian government reacted to the spread of the COVID-19 virus on 23 February 2020 by issuing Decree 6/2020 of the President of the Council of Ministers. This Decree introduced urgent measures to contain and manage the epidemiological crisis. In implementing that Decree, Decree-Law 18/2020 of 17 March 2020 laid down a series of measures. Article 91 states that compliance with containment measures taken by the authorities must always be taken into account to: a) exclude the debtor's liability for failure to comply with obligations and the compensation due for non-compliance; b) exonerate the debtor from the payment of compensation contractually provided for in penal clauses, due as a result of non-compliance or delay in compliance. The scope of article 91 is not yet entirely clear and will have to be assessed by the judge. However, the article does seem to exclude the possibility of imputing to the debtor a breach imposed by a legislative measure to combat COVID-19. It is concluded that a party which fails to fulfil its obligations because of a government measure taken to combat the epidemic is not liable for the failure or delay in fulfilling the obligations.

Moreover, in broader terms, the Italian Civil Code provides in article 1256 (permanent or temporary impossibility) that the obligation is extinguished when, for reasons beyond the control of the debtor, performance becomes impossible.

Impossibility occurs when the fact is entirely outside the debtor's control and the debtor could not reasonably have foreseen it when the obligation arose. The impediment must occur before the affected party can no longer comply³⁶ and the risk of its occurrence cannot have been assumed explicitly or implicitly³⁷.

In broader terms, the Italian Civil Code provides that the obligation is extinguished when, for reasons beyond the control of the debtor, performance becomes impossible.

³⁶ Sacco, Rodolfo e De Nova, Giorgio, *Il Contratto* (Tomo II, Torino UTET, 1993), p. 652.

³⁷ *Ibid*, p. 653.

The Swiss Code of Obligations enshrines rules on impossibility of compliance. This rules only applies if the impossible event is of a permanent nature.

The rules on impossibility also apply to cases where the creditor is unable to receive the benefit for a reason not imputable to it³⁸. As a result and for example, a passenger who, through no fault of his own, becomes ill and cannot benefit from the airline ticket he has booked may terminate the contract and be reimbursed for the money spent on the booking.

If the impossibility is only temporary, the debtor is not responsible for the delay in performance as long as the impossibility persists. However, temporary impossibility becomes definitive impossibility, with the effect of extinguishing the obligation, if, given the source of the obligation or its nature, the debtor can no longer be obliged to perform or the creditor no longer has an interest in performance³⁹. This would be the case, for example, if a supply was only necessary for a certain period of time.

A debtor that is totally unable to fulfil its obligations may not demand consideration and must return everything it has received for contractual performance. If the impossibility affects only part of the performance, the other party is entitled to a corresponding reduction in the consideration (articles 1463 and 1464 of the Italian Civil Code).

Italian case law holds that an administrative measure preventing performance of an obligation does not relieve the debtor of the obligation to perform, provided that decision is reasonably foreseeable by a debtor that is moderately diligent⁴⁰. That criterion may have to be taken into account when applying article 91 of Decree-Law 18/2020 of 17 March 2020 which, as we have seen, states that any party that fails to fulfil its obligations because of a government measure taken to combat the epidemic is not liable.

It should also be noted that, according to Italian case law⁴¹, failure to perform a contract (e.g., a supply contract) which calls into question the performance of another, does not automatically release the debtor from its obligations under second contract and all the circumstances of the case must be assessed. However, it also appears from the case law that, where non-performance results from an impossibility to perform, the creditor affected by the non-performance may be exonerated from successive performance towards its own creditor, according to a broad concept of impossibility⁴².

Switzerland

The Swiss Code of Obligations enshrines rules on impossibility of compliance⁴³. This rules only applies if the impossible event is of a permanent nature. If the event that makes performance impossible is of a merely temporary nature, the rules on impossibility do not apply. This may occur, for instance, if it is due to a measure limiting exports or imposing quarantine. In that case, the rules on delay apply.

The impossibility must be extraordinary, unpredictable and inevitable, and it must not be possible to prevent it with due care⁴⁴.

38 See, for example, the judgment of 22.05.2019 of the court of first instance in Florence, P. no. 1581.

39 Sacco, Rodolfo and De Nova, Giorgio, *Il Contratto*, ob. cit.


40 See, for example, judgment of 23.02.2000 of the Italian Supreme Court, P. no. 2059.

41 See, for example, judgment of the Court of Milan no. 8335/2017.

42 See, for example, judgment of 29.05.1998 of the Italian Supreme Court, P. no. 5327.

43 Article 119(1) of the Swiss Code of Obligations.

44 Article 119(1) of the Swiss Code of Obligations.



The impossibility
must be
extraordinary,
unpredictable
and inevitable,
and it must not be
possible to prevent
it with due care.

For it to be impossible, compliance must be objectively impossible, and the debtor cannot be held liable for these circumstances.

For it to be impossible, compliance must be objectively impossible, and the debtor cannot be held liable for these circumstances. Performance is objectively impossible when no one can perform (unless the third person that can perform is not determinable or reachable). Impossibility also includes cases where: (1) compliance is personal and the debtor is incapacitated; (2) compliance is impracticable, such that no reasonable person would consider attempting to perform; (3) the objectives of the contract are achieved before the debtor has had an opportunity to perform (e.g., the illness is cured before the doctor arrives); (4) the objectives of the contract are frustrated before the debtor has had an opportunity to perform (e.g., the patient dies before the doctor arrives)⁴⁵.

If there is an impossible event of a temporary nature, the creditor must clearly and expressly demand compliance (e.g., by sending an invoice) and must set itself a reasonable deadline within which the debtor must comply⁴⁶. After the deadline has passed, the default becomes a definitive breach.

If the performance of the contract is effectively impossible, the creditor will not be able to demand the performance of the contract in court. Similarly, if the failure to perform is not attributable to the debtor, and the burden is on the debtor to prove this,⁴⁷ the creditor is not entitled to compensation. The creditor has the option of terminating the contract (Rücktritt) and this option must be notified immediately⁴⁸. Termination has retroactive effect. This entails the return of everything that has been provided, unless the terminated contract is of a long-standing nature. In this case, it takes effect only from the time of non-performance. If the delay relates to only part of the performance, the creditor may reject the partial performance and terminate the whole contract. However, if the creditor accepts part of the performance, he may only partially terminate the contract⁴⁹.

Alternatively, the fact that prevents compliance may be of a permanent nature. In this case, provided the affected party has not contributed to the fact that makes performance impossible, the parties are released from their obligations and must return what they have already obtained under the contract at the expense of the other party. The affected party may not be held liable for the non-performance. Economic impossibility or commercial impracticability are not covered by the concept of impossibility.

With regard to administrative decisions taken by the government as a means of combating the spread of COVID-19, it should be noted that the Swiss courts include them within the concept of legal impossibility. For example, the Swiss Federal Supreme Court has already classified a ban on exports of certain types of machinery that could be used in the production of nuclear weapons, as a supervening legal impossibility. However, the court specified that the seller of the goods covered by the ban may still be held liable for non-compliance if it knew or should have known of the future embargo when the contract was concluded⁵⁰. In the context of the current epidemic, it is necessary to consider the foreseeability of the measures adopted.

International legal instruments

We will now analyse the United Nations Convention on Contracts for the International Sale of Goods (CISG)⁵¹, the UNIDROIT Principles of International Commercial Contracts (PICC) and the Principles of European Contract Law (PECL).

45 Rivkin, David R., "Lex Mercatoria and Force majeure" in Gaillard (ed.), *Transnational Rules in International Commercial Arbitration* (ICC Publication no. 480(4)), 1993.

46 Under article 107 of the Swiss Code of Obligations. See Szladits, Charles, "Discharge of Contract by Breach in Civil Law", in *The American Journal of Comparative Law*, 2(3), 1953, p. 344.

47 Szladits, Charles, "Discharge of Contract", ob. cit., p. 348.

48 Ibid, p. 345.

49 Partial termination under Article 107 of the Swiss Code of Obligations.

50 Judgment of 03.09.1985, Swiss Federal Supreme Court, P. no. 111 II 352.

51 On the relevance and applicability of these instruments, see footnotes 3, 4 and 5.

The PECL differs in that it equates a considerable delay with definitive non-compliance.

Like most of the national legal systems described here, the international legal instruments we have analysed exempt debtors from liability when an event occurs that makes performance impossible. It should be noted that the CISG, the PICC and the PECL adopt a criterion of “reasonableness” in defining the predictability and inevitability of the impossible event and its effects.

According to the CISG, “A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences”⁵². The CISG does not expressly recognise relative impossibility as an exception to the obligation to perform and does not enshrine it. However, as Hans Stoll argues, it follows from the general principles of the CISG that “if there is a subsequent and unforeseeable impediment to performance as a result of a substantial change in economic conditions, there must be a ‘sacrifice limit’ beyond which, in view of the economic disadvantage involved, the debtor is not required to comply”⁵³.

The wording of the PICC⁵⁴ and PECL is very similar⁵⁵ to that of the CISG. However, the PECL differs in that it equates a considerable delay with definitive non-compliance.

Of the three international legal instruments, the CISG definition is the only one which clarifies that, in the event of one party’s failure to perform its obligations owing to the failure of a third party who has been contracted to perform all or part of the contract, that party will be exempt from liability only if the requirements of impossibility with regard to both the contractual party and the third party contracted are met.

Regarding the practical application of these legal instruments, we note three relevant arbitration awards in the context of this epidemic, which had the CISG as applicable law:

- In one case, the seller’s supplier had technical problems that affected its production capacity. The arbitral tribunal concluded that, as the contract did not specify the identity of the supplier of goods, the seller was obliged to seek other suppliers. Similarly, if a party affected by a fact relating to COVID-19 that prevents the performance of the contract is not bound to perform the obligation personally, it must make use of all alternative means to comply⁵⁶.
- A case in which, according to a custom of international law, the court arbitral tribunal held that the risk of not obtaining an import licence lies with the buyer (importer)⁵⁷. This decision shows that there are certain facts which, if they fall within the sphere of risk of one of the parties, do not allow them to rely on the impossibility.
- A case in which one of the parties invoked the spread of SARS as a force majeure event and the arbitral tribunal concluded that that virus already existed before the parties entered into the contract. This removed the element of unpredictability. In addition, the party affected took months to inform the other party of the impediment. This was held to be unreasonable and the former was ordered to pay damages for the delay in performance until that date⁵⁸.

52 Article 79, no 1 of the CISG, available [here](#).

53 Hans Stoll, commentary on article 79, in: Peter Schlechtriem (ed.), *Commentary on the UN Convention on the International Sale of Goods (CISG)* 618 (2d. ed. 1998).

54 Article 7.1.7 (Force Majeure) of the PICC.

55 Article 8:108 (Justification due to an impediment) of the CLCP.

56 Decision of the CIETAC (China International Economic and Trade Arbitration Commission) of 17.06.1994, Warm rolled steel plates case, [available online](#), and cited by Larry DiMatteo, “Contractual excuse under the CISG: impediment, hardship, and the excuse doctrines”, 27 Pace International Law Review 258, 285.

57 Among others, the arbitral decision of the CIETAC of 07.08.1993, semi-automatic weapons case, available [here](#).

58 Arbitral decision of the CIETAC of 05.03.2005, L-Lysine case, available [here](#).

2. Change of circumstances

In some countries, the possibility of renegotiation or termination depends on whether the contract in question is of a continuous or periodic nature, or one of deferred performance.

The vast majority of legal systems allow the parties to renegotiate or terminate the contract if, after its conclusion, an event occurs that alters the assumptions on which the parties based their decision to contract and substantially affects the contractual balance. In some countries, the possibility of renegotiation or termination depends on whether the contract in question is of a continuous or periodic nature, or one of deferred performance (e.g. Italy, Spain and Brazil). The rules on a “change of circumstances” are not always enshrined in law and may result from the practice of the courts (e.g., China, Spain and Switzerland). Of the legal systems analysed, the United Kingdom is the only one that does not attribute legal effectiveness to a change of circumstances. However, the doctrine of frustration ultimately remedies this solution.

It should be noted that the parties can always set out their own conditions for a review or termination in the contract. They can also allocate the risks in a certain way. This type of contractual provision takes precedence over the supplementary rules resulting from the law. In the following paragraphs, we will analyse the legal requirements for the application of the rules on a change of circumstances in each national legal system (Angolan, Brazilian, Chinese, English, French, German, Italian, Spanish and Swiss). Finally, we will set out the solutions established in the CISG, the PICC and the PECL⁵⁹.

Germany

The German Civil Code (“BGB”) includes the doctrine known as Wegfall der Geschäftsgrundlage (change in the circumstances on which the contract was based) in paragraph 313. Thus, if the circumstances on which the parties based their decision to enter into a contract have substantially changed, the parties may require the contract to be adapted, if its performance is no longer enforceable or, if adaptation is not possible or appropriate, to be terminated. A substantial alteration is one that fundamentally alters the balance of the contract and is so significant that, if the parties had foreseen such an alteration, they would not have entered into the contract in the terms they did.

The adaptation of the contract can take several forms: restructuring or partial maintenance of the legal relationship, alteration of the amount due or the content of the obligation, postponement of performance, etc.⁶⁰. The negotiating capacity of the parties and their creativity and openness to new solutions is essential here, and it could be improved through alternative dispute resolution mechanisms such as negotiation following the cooperative model or mediation.

⁵⁹ On the applicability and relevance of these pieces of legislation, see footnotes 3, 4 and 5.

⁶⁰ Rauh, Theo, “Legal Consequences of Force Majeure under German, Swiss, English and United States”, *Denver Journal of International Law and Policy* 25, 1996-1997, p. 153.

If the contract affected is one of long-term performance and the contractual legal relationship cannot be maintained until the end of the term or until the expiry of a notice period, either party may terminate the contract for an important reason without notice⁶¹. The party exercising this right must notify the other party within a reasonable period of time from the moment it becomes aware of the reason for termination of the contract.

The courts have already applied the doctrine of a change in the basis of the decision to enter into the contract in various types of situation. It has been applied, in particular, in cases of political reforms⁶², legislative changes⁶³, legal prohibition on concluding or fulfilling certain contracts⁶⁴ and frustration of the purpose of the contract, for example, when the lease of a shop in a new shopping centre provides for the operation of the shop, but the shopping centre proves to be a failure⁶⁵⁻⁶⁶.

As a general rule, the rules on a change of circumstances do not apply if the performance affected is of a pecuniary nature. This means the debtor bears the risk of inflation⁶⁷. With specific regard to the loan agreement, under paragraph 490 of the BGB, if a deterioration in the financial circumstances of the borrower or in the value of a security given for the loan jeopardises the repayment of the loan, the lender may terminate the loan agreement.

61 See section 314 of the BGB.

62 OLG Düsseldorf NJW 1955, 1797.

63 BGH NJW 1951, 836.

64 BGHZ 38, 146

65 BGH NJW 1978, 2510.

66 These cases are cited by Horn, Norbert, "Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law" in Horn (ed.), *Adaptation and Renegotiation of Contracts in International Trade and Finance* (1985).

67 Rösler, Hannes, "Hardship in German Codified Private Law: In Comparative Perspective to English, French and International Contract Law", *European Review of Private Law (ERPL)* 15, 2007, pp. 483-513.



In the context of COVID-19, judicial decisions have already recognised that the conditions for a change in circumstances have been met.

If a situation arises that falls under both impossibility and a change of circumstances, the courts prefer to apply the latter. Thus, for example, if the validity of a contract depends on the issuance of an administrative authorisation that has been refused, but is granted if the contract is amended, the parties are obliged to accept the amendment⁶⁸.

Angola

Under the terms of Ministerial Order 22869 of 4 September 1967, issued by the Overseas Ministry (Directorate-General for Justice), the effectiveness of the Portuguese Civil Code was extended to Angola, as approved by DL 47344 of 25 November 1966. Although this Code has undergone its own amendments in Angola, the rules on impossibility of compliance remain unchanged. We therefore refer to what we have already written on the management of the risk of breach of contract under the Portuguese rules⁶⁹.

Brazil

The Brazilian Civil Code establishes that if there is a change in circumstances, the debtor has the right to demand termination of the contract. Faced with the exercise of this right, the creditor may offer to adapt the contract⁷⁰, in which case the parties must renegotiate the contractual terms in good faith. Naturally, there is nothing to prevent the debtor itself from proposing an adaptation of the contract in the first place. In article 317, the Brazilian Civil Code also provides, as a clarification⁷¹, that if the change of circumstances affects performance of a pecuniary obligation that generates a manifest disproportion between the value of the obligation originally due and the one due at the time of performance, including as a result of inflation, the affected party may appeal directly to the court, requesting the correction of the value of the performance.

The institute of the change of circumstances depends on certain requirements. Firstly, the contract must be of continuous or deferred performance and the event that changes the circumstances must occur between the signature of the contract and the performance. Secondly, the supervening event must be extraordinary (in light of its frequency and intensity) and unpredictable (by reference to the ability to anticipate the event and its impact, in the light of a standard of average diligence). Thirdly, the benefit obligation to be performed that is affected must become excessively onerous, given the original balance of obligations, and it must lead to a disproportionate advantage for the creditor. This advantage is verified if it is proved that the creditor has ultimately obtained an advantage that it could not have obtained under normal circumstances. Finally, it must be established that there is a causal link between the event and the higher cost of performing the obligation

In the context of COVID-19, judicial decisions have already recognised that the conditions for a change in circumstances have been met. For example, in a preliminary ruling, the São Paulo State Court of Justice acknowledged that government measures had prevented the claimant from carrying out her catering activity, and this had drastically reduced her invoicing. In this case, the court decided to reduce by 30% the amount of rent that the claimant, the lessee of the restaurant space, was required to pay⁷². However, this is not a definitive decision.

68 Horn, Norbert, "Changes in Circumstances", ob. cit.

69 PLMJ (Morais Antunes, João Tiago, Figueiredo, André e Schmidt Lino, Duarte (coord.)), "Coronavirus: Managing the risk of breach of contract", available [here](#).

70 See articles 478 to 480 of the Brazilian Civil Code.

71 Explaining that article 317 of the Brazilian Civil Code introduces a specification of the object, but not a contradiction between rules, so that the aggrieved party may also resort to the termination of the contract, pursuant to article 478, see José de Oliveira Ascensão, "Alteração das circunstâncias e justiça contratual no novo Código Civil", *Revista CEJ* 8(25), pp. 59-69.

72 Court of Justice of the State of São Paulo, P. no. 1026645-41.2020.8.26.0100, of 02.04.2020.

China

Although the change of circumstances was not included in the law of Contracts of the People's Republic of China, in May 2009, the Supreme Court of Justice issued an "Interpretation" ("Second Interpretation of Contracts Law"). Then, in July 2009, it issued a Guiding Opinion formalising the recognition of the institute⁷³.

The implementation of the change of circumstances depends on meeting various requirements. First, a substantial change in objective circumstances must have occurred after the contract was entered into. Secondly, it is necessary that this change could not have been foreseen at the time the contract was signed. Thirdly, it must make it manifestly unfair to one of the parties to maintain the contractual relationship as originally defined or make it impossible to achieve the objectives of the contract. Finally, the fact must not be classifiable as force majeure and it must not fall within the commercial risks inherent to the nature of the business.

The principle of good faith also requires that one party notify the other as soon as possible of any change in circumstances that might affect compliance.

If all the requirements are met, the parties must renegotiate the terms of the contract. If an agreement cannot be reached, they may ask the court to adapt or terminate the contract⁷⁴.

The principle of good faith also requires that one party notify the other as soon as possible of any change in circumstances that might affect compliance⁷⁵.

An example of the application of the rules on changes of circumstances is the decision of the Chinese Supreme Court in case no. 27/1992. The case involved a contract for the supply of components for gas meters.

The price of aluminium ingots, which are essential components of the meters, was fixed by the State.

However, the price of ingots quadrupled following the liberalisation of the market, the court applied the rules on changes of circumstances⁷⁶. The court thus held that there had been a change of circumstances, in this case a legislative change. None of the parties could have foreseen this change and it was not a commercial risk inherent to the nature of the business.

In another case - *Xinbaiwan Catering Co. Ltd. of Zhangjaikou and Xuanhua Hotel Ltd*⁷⁷ - a catering company rented a hotel a space where it would carry out its activity, for a certain price that already included the expenses of essential services such as water and electricity. However, due to special circumstances, which the decision did not identify, but which were not caused by negligence on the part of the party affected, the amount the hotel paid for the expenses exceeded the amount received from the catering company. The court found that this situation went against the assumption on which the parties had based their decision to contract. This assumption was that the hotel would make a profit from the lease. Therefore, the court decided to adapt the contract on the basis of the change of circumstances.

Spain

The Spanish Civil Code does not enshrine any rules on the substantial change of circumstances. However, for several decades case law has developed this institute. It has admitted exceptional terms for long-term, continuous or deferred performance contracts.


⁷³ Herbots, Jacques H., *Contracts in the People's Republic of China: an outline of the Chinese law from the perspective of Europe and Hong-Kong* (Die Heure Publishing, 2018).

⁷⁴ Larry DiMatteo, "'Rule of Law' in China: the confrontation of formal law with cultural norms", *Cornell International Law Journal*, 51(2), p. 52.

⁷⁵ *Ibid*, p. 42.

⁷⁶ *Ibid*.

⁷⁷ Judgment quoted by Ziya Baghirzade, *Change of Circumstance. Approach to the doctrine of "change of circumstance" in different countries and legitimacy of this doctrine*, 2013, Munich, GRIN Verlag, available at <https://www.grin.com/document/265961>.



If the requirements for the application of the rules on a change of circumstances are met, the affected party may ask the other party to renegotiate the contract and it must continue to perform its obligations during the renegotiation.

For a substantial change of circumstances to apply, a set of specific requirements must all be met. First, there must be an extraordinary change in the circumstances on which the contract was based. This change must take place between the time the contract was signed and its performance. Secondly, this occurrence must be absolutely unforeseeable. Thirdly, there must be a significant disproportion between the obligations performed by the contracting parties, making the contract excessively onerous for one of them or frustrating its purpose. Finally, there must be no other means of correcting the imbalance than adapting or terminating the contract.

If all the requirements are met, the affected party, to whom it cannot reasonably be required to remain bound by the contract, given the circumstances of the case and the contractual or legal distribution of risks, may require the contract to be revised, and the parties must negotiate in good faith. If adaptation of the terms of the contract is not possible or appropriate, the affected party may ask for its termination.

Recently, case law has addressed the applicability of changes of circumstances in connection with the 2008 economic crisis. In some cases, it has held that the requirements were met. A 2019 decision of the Portuguese Supreme Court, states that “an economic recession such as the current one, with deep and prolonged effects, can be described as an extraordinary change in circumstances if the contract was signed before the external appearance of the crisis,”⁷⁸. However, there have been other decisions to the effect that the economic crisis is part of the normal economic cycle. Therefore, it should not be considered unpredictable and the rules of a change of circumstances will not apply⁷⁹.

France

In February 2016, France codified the rules on changes of circumstances in its Civil Code. The new rules apply to contracts made or renewed after that date, and the following requirements must be met:

First, an unforeseeable event must have occurred and it must be unforeseeable from the point of view of a reasonably prudent professional placed at the time the contract is signed. Secondly, compliance must become excessively onerous for the party affected. Since this is a pecuniary obligation, the notion of being excessively onerous includes an objective reduction in the value of the consideration⁸⁰. Thirdly, the party affected cannot have accepted the risk of an unforeseeable change of circumstances. The risk will have been accepted if, for example, the parties have provided for a price variability clause or even a minimum and maximum price in the event of a change in turnover. In the case of speculative contracts, the risk is understood to be foreseeable, and the party has therefore implicitly accepted it⁸¹.

The change of circumstances does not apply if it conflicts with another specific set of rules. Thus, for example, the Versailles Court of Appeal refused to apply article 1195 in a matter relating to a commercial lease. The court noted that there are specific French rules applicable to commercial leases which already contain provisions relating to the revision of the lease (Versailles Court of Appeal, 12 December 2019, no. 18/07183). According to the same logic, the rules on a change of circumstances do not apply to financial securities or fixed-term financial instruments (as defined in paragraphs I to III of Article L211.1 of the French Monetary and Financial Code).

If the requirements for the application of the rules on a change of circumstances are met, the affected party may ask the other party to renegotiate the contract and it must continue to perform its obligations during the renegotiation. In the event of refusal or failure of the renegotiations, the parties may ask the courts to intervene to adapt or terminate the contract.

An analysis of the most recent case law shows that the French courts are very reluctant to apply these rules. For example, they have already refused to apply the rules on a change of changing circumstances in a case where a company proved increases of 4% to 16% in the prices charged by its suppliers, leading to a 58% reduction in its gross margin⁸².

In addition to the rules on a substantial change of circumstances, specific legislative measures have already been approved in France in response to the effects of COVID-19. Decree (“Ordonnance”) 2020-306 of 26.03.2020, recently amended by Decree 2020-427 of 15.04.2020, provides a set of special rules for contracts affected by COVID-19.

Thus, the effect of contractual penalties for any delay in meeting monetary obligations that had to be met between 12 March and 23 June 2020 was postponed.

The date on which these clauses take effect is postponed until the end of a period after 23 June 2020, which is equal to the time between (i) 12 March 2020 or the date on which the litigious obligation was created, if the latter date is later, and (ii) the date on which that obligation should normally have been met.

There is also a postponement in the case of non-pecuniary obligations which have to be performed within a defined period of time, the expiry of which is after 23 June 2020. The effect of contractual clauses seeking to sanction the delay in performance is postponed from the date on which they should normally have taken effect until the expiry of a period equivalent to the time between (i) 12 March 2020 or the date on which the obligation was created, whichever is the latest, and (ii) 23 June 2020.

78 Judgment of the Supreme Court of Justice (first chamber, civil), case no. 820/2013, 17 January (Francisco Marín Castán), ES:TS:2013:1013.

79 See, for example, the judgment of the Spanish Supreme Court (first chamber, civil), case no. 214/2019 of 5 April (María Ángeles Parra Lucán), ES:TS:2019:1148.

80 Répertoire de droit civil Dalloz, Imprévision - Droit positif français après la réforme - Pascal ANCEL - May 2017 (updated: May 2018).

81 Paris Court of Appeal, 16 February 2018, no. 16/08968.

82 Judgment of 12 February 2015 of the French Court of Cassation, P. no. 12-29.550.

In addition, there is an extension when a contract can only be terminated within a specific period of time or where a contract is automatically renewed in the absence of formal termination within a specific period of time, and that period of time or deadline expired between 12 March 2020 and 23 June 2020. This period of time or deadline has been extended by an additional two months after 23 June 2020.

United Kingdom

English law does not have a doctrine of change of circumstances.

However, the doctrine of frustration (already examined in the part on Impossibility)⁸³ may in certain cases release the parties from their obligations. However, the courts are extremely strict in its application. The courts reiterate that *“it is not a difficulty in complying or an inconvenience or an economic loss in itself that makes it possible to invoke the principle of frustration. There must be a change in the meaning of the obligation in such a way that the thing promised, if performed, becomes something other than that which was contracted”*⁸⁴.

In the famous Suez Canal case, the closure of the canal because of the war made the fulfilment of supply contracts much more costly and time-consuming, as alternative routes had to be used. However, since the use of these routes was possible, the courts found that the affected party was not relieved of its obligation. In the case of *Davis Contractors v Fareham Urban DC (1956) AC 696*, there was a works contract in which the contractor had undertaken to build 78 houses in 8 months. However, the contract was concluded in 1946, and there was a large reduction in the workforce. This meant the works took 22 months to complete. The contractor claimed that the original contract had been frustrated, and that it should be paid on an equitable basis in an amount greater than had originally been agreed. However, the court found that although the work proved more expensive, it did not become a different type of work from that provided for in the contract. Therefore, there was no change in the contracted price

Nevertheless, there are already examples of decisions in which the courts applied the doctrine of frustration to cases where there was a dramatic increase in the contractual price.

Nevertheless, there are already examples of decisions in which the courts applied the doctrine of frustration to cases where there was a dramatic increase in the contractual price. For example, the court allowed the parties to terminate a water supply contract for a fixed price. The contract was made more than sixty years ago and, due to inflation, the compliance costs far exceeded the stipulated price⁸⁵. It should be noted that, in such cases, the parties acquire the power to terminate the contract, but not to modify it. However, apart from a few borderline examples where the change of circumstances occurred fundamentally, the English courts are very reluctant to apply the doctrine of frustration broadly. The doctrine of impracticability is not accepted in English law, unlike in the US⁸⁶.

Italy

Italy has legally recognised the institute of a change of circumstances (*eccessiva onerosità sopravvenuta*) in article 1467 of the Italian Civil Code. For the institute to apply, the following requirements must be met:

83 See p. 14 of this document.

84 Beale, H., et al. Cases, Materials and Text on Contract Law. Oregon: Hart Publishing, 2002, p. 617-619.

85 *Staffordshire Area Health Authority v. Staffordshire Staffs Waterworks Co*, cited by Egidijus Baranauskas and Paulius Zapolskis, “The effect of Change in Circumstances on the Performance of Contract”, *Jurisprudence*, 2009, 4(118) 197, 203.

86 Baranauskas and Paulius Zapolskis, “The effect of Change in Circumstances”, *ob. cit.*, p. 203.

Firstly, the contract affected must be one of continuous or periodic performance, or of deferred performance. Secondly, an extraordinary and unforeseeable event must occur. This event must alter the original balance of the obligations to be performed and make the obligations of one of the parties excessively onerous. The question of whether or not the obligations have become excessively onerous is assessed objectively. Thirdly, the nature of the contract (e.g., random contracts) and the distribution of the contractual risk must be analysed. This analysis is necessary because the affected party may have assumed the risk of the event occurring. If that is the case, the affected party cannot invoke the change in circumstances. Indeed, in certain contractual sectors, such as chartering and raw materials supply contracts, there are rapid price fluctuations over short periods of time. These fluctuations are risks specific to the party affected⁸⁷. Finally, the fact must arise after the contract has been signed and the debtor cannot be in default when the fact occurs.

If these requirements are met, the affected party may ask the courts to terminate the contract, but not to adapt it. Only the creditor can propose a revision of the terms of the contract when faced with the request for termination.

The court objectively assesses the appropriateness of the proposal to amend the contract and may determine an equitable revision of the contract on the terms it considers most appropriate⁸⁸. According to the decision-making practice of the courts, the purpose of adapting the contract is not to establish the contractual balance between the parties. Instead, it is simply to eliminate the abnormal disproportion which gave rise to the application of the rules on changes in circumstances. Thus, the party affected will still suffer the negative consequences of the change of circumstances, but within the limits of normal tolerability⁸⁹.

Switzerland

In Switzerland, the doctrine of change of circumstances is not legally accepted. Instead, it results from case law development. The doctrine is known as the *rebus sic stantibus* clause. The Swiss Code of Obligations only contains (in article 373(2)) a specific article with regard to works contracts. This article gives the courts the option of increasing the contractor's remuneration. Alternatively, and on a supplementary basis, it can terminate the contract if completion of the work has become excessively onerous due to a change in circumstances.

The application of the doctrine of a change in circumstances depends on meeting various requirements. First, the fact causing the change of circumstances must occur after the contract has become effective. Secondly, the change of circumstances renders the obligation excessively disproportionate for one of the parties. Demanding compliance must prove abusive, from the perspective of any impartial third party. Third, that the parties must not have contractually distributed the risk of the event giving rise to the change of circumstances. If they have, the contractual provisions prevail. Fourth, the change of circumstances must not be reasonably foreseeable and it must not have been actually foreseen by the parties. Finally, the change of circumstances must not be attributable to the party affected.

The party affected
will still suffer the
negative consequences
of the change of
circumstances, but
within the limits
of normal tolerability.

If a change in circumstances does apply, the affected party may ask for the contract to be adapted or, if this is not appropriate, terminated. When adapting the contract, the courts are careful not to transfer the consequences of the event entirely to the creditor.

However, doctrine and case law are very demanding when assessing these requirements. They only apply a change of circumstances in very specific situations, especially when this is justified in good faith.

87 Elena Christine Zaccaria, "The Effects of Changed Circumstances in International Trade", *International Trade and Business Law Review* (2004) 9.

88 Judgment of 18.07.1989 of the Italian Court of Cassation, no. 3347, *Foro italiano*, 1990, I, 565.

89 Judgment of 11.02.1992 of the Italian Court of Cassation, no. 247, *Giurisprudenza italiana*, 1993, I, 1, 2018.

In ICC ruling 11585⁹⁰, in which Swiss law applied, there was a financial contract which was affected by the economic crisis in Turkey. The investor claimed that, even if the occurrence of any of the economic events was foreseeable, their combined dramatic effect was not, and it concluded that the economic crisis amounted to a change of circumstances. However, the ICC held that the unusual accumulation of events over a period of several years was not sufficiently “extraordinary”. The court also found that it neither affected nor dramatically destroyed the balance of obligations between the parties. Furthermore, it did not consider that the requirement of unpredictability had been met.

Like the PECL,
the PICC focus
on excessive burdens
as an essential
criterion for a change
of circumstances.

International legal instruments

We will now analyse the United Nations Convention on Contracts for the International Sale of Goods (CISG), the UNIDROIT Principles of International Commercial Contracts (PICC) and the Principles of European Contract Law (PECL)⁹¹.

The CISG does not contain any rules that specifically address changes of circumstances. We have presented article 79 of the Convention in the section on impossibility. This article exonerates the debtor in the event of an impossibility and some argue that it also applies to situations where it is more difficult to comply⁹². This is the meaning of Opinion no. 7 of 2008, published by the CISG Advisory Council. However, the case law is unclear on this point⁹³ and it is difficult to remove an obligation to renegotiate from the article, as it only provides that the debtor is exempt from liability for as long as the impediment lasts⁹⁴.

The PICC and PECL devote a specific article to change of circumstances. Chapter 6, section 2, of the PICC is entitled “hardship”. Article 6.111 of the CLP is entitled “change of circumstances”.

Like the PECL, the PICC focus on excessive burdens as an essential criterion for a change of circumstances. To determine whether a change in contractual balance is fundamental, the PICC use two objective criteria: 1) an increase in the cost of compliance, or 2) a decrease in the value of the consideration⁹⁵. As for the increase in the cost of compliance, it is considered that the risk of not having the financial capacity to comply does not allow the affected party to be released from responsibility, except in the event of insolvency. As for the decrease in the value of the consideration, according to the official comments on the PICC, this may be a question of a drastic change in market conditions or a frustration of the purpose of the contract⁹⁶.

Both the PICC and the PECL provide that it is essential for the facts to be supervening. However, the definition differs in the two texts. For the PICC, the events must occur or become known to the affected party after the contract has been signed. For the PECL, the essential thing is that the change of circumstances actually takes place after the contract has been signed, regardless of when the affected party becomes aware of it.

90 Cited by Matthias Scherer, “Economic or Financial Crises as a Defence in Commercial and Investment Arbitration”, in Czech Yearbook of International Law – Second Debate Ahead: Tracing the Global Crisis”, Alexander J. Belohlávek and Nadezda Rozehnalová (eds.), vol. 1, 2010, pp. 224–227.

91 See p. 3 of this document.

92 Marcel Fontaine, “The Evolution of the Rules on Hardship. From the First Study on Hardship Clauses to Enactment of Specific Rules”, in *Hardship and Force Majeure in International Commercial Contracts. Dealing with unforeseen events in a changing world*, Fabio Bortolotti e Dorothy Ufot (eds.), International Chamber of Commerce.

93 Larry DiMatteo, “Contractual excuse under the CISG: impediment, hardship, and the excuse doctrines”, 27 Pace International Law Review 258, 272. The case law cited below has been analysed by this author.

94 Ob. cit., p. 284

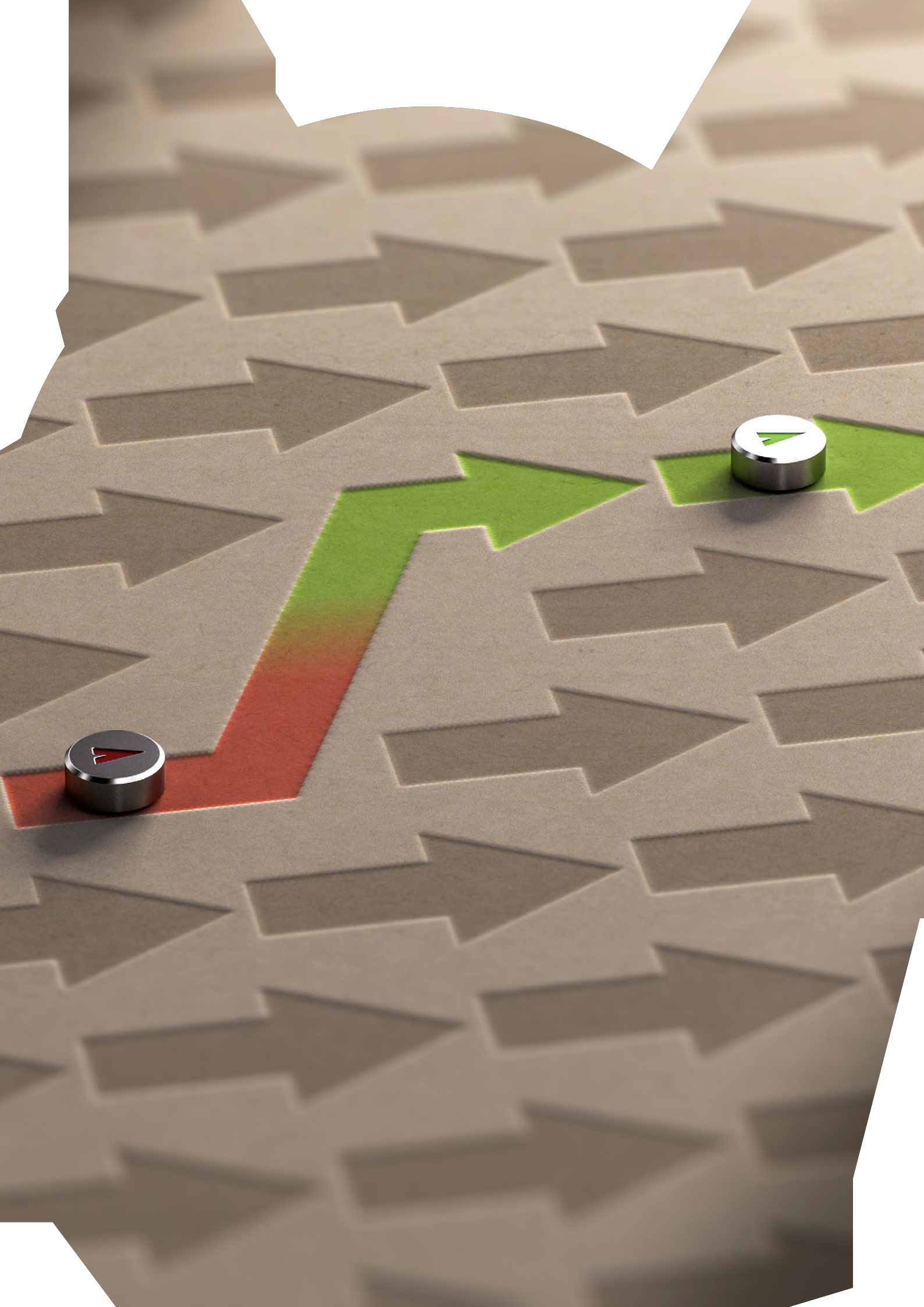
95 Baranauskas and Paulius Zapolskis, “The effect of Change in Circumstances”, ob. cit., p. 209

96 Ibid.

In both documents, as in most of the national legal systems examined, the fact must be reasonably unforeseeable at the time the contract is signed and the affected party must not have contractually assumed the risk of the event occurring. The PICC also specify that the fact must be outside the sphere of control of the affected party. Faced with a hardship, the parties must first negotiate in good faith between themselves. The request for renegotiation must be well-founded and submitted as soon as the event occurs. If they fail to reach an agreement within a reasonable time, each of them may turn to the courts, which may either terminate the contract or adapt it.

But what is the limit on the other party's obligation to renegotiate in good faith? The court will make an assessment when the affected party brings an action asking the court to adapt or terminate contract. At this time, the court may consider the damage suffered due to the actions of the party that refuses to negotiate or breaks off the negotiations in a way that is contrary to good faith⁹⁷.

97 Larry DiMatteo, "Contractual excuse under the CISG: impediment, hardship, and the excuse doctrines", 27 Pace International Law Review 258, 273.



3. Contractual provisions

Force majeure clause

By means of a force majeure clause, the parties contractually regulate the legal means at their disposal in the event of the occurrence of an event that renders performance impossible. They detail specifically, in a way that may differ from the legal regulations, the requirements that define a force majeure event. The parties may indicate, by way of example, the types of situation they classify as force majeure events. If the epidemic or acts of government are not referred to in the clause, the affected party may still claim that the general requirements for force majeure have been met. Alternatively, when the parties agree on a closed list of events, if the event in question is not listed, the affected party may not resort to the rules on force majeure.

In addition to the definition of force majeure, the contractual clauses also specify what rights the parties have, and they can extend, restrict or detail the rights provided for by law. Thus, the contract may establish, for example, the right of the affected party to be reimbursed for the additional costs of performing its obligations or to an extension of the term. The clause may also specify the circumstances that give rise to the right of termination, beyond the qualitative criteria resulting from the law. In addition, certain doubts resulting from the interpretation of the law may be overcome. For example, to overcome the question of what constitutes appropriate notice, the parties can introduce a specific notice period. They can also specify the consequences of not informing the other party in time. Some argue that failure to comply with the notification obligation results in the loss of the right to invoke force majeure⁹⁸. However, others argue that the delay simply gives the unaffected party the right to recover any losses resulting from the delay in notification.

The parties may indicate, by way of example, the types of situation they classify as force majeure events

As a rule, the legal rules governing force majeure or impossibility of performance are not part of public policy. Therefore, the legal provisions may be amended by the contract.

However, there are certain exceptions. For example, some legal systems, particularly those of the European Union countries⁹⁹, limit the content of contract terms inserted in contracts made without prior individual negotiation. This is particularly so where relations with end consumers are involved¹⁰⁰. For example, general contract terms which alter the rules on the distribution of risk in relationships with end consumers will be null and void¹⁰¹. Even terms inserted in contracts between traders ("B2B2"), the exclusion from the scope of force majeure of a situation in which the party could not control the fact or, conversely, the inclusion in the scope of force majeure of cases which could have been avoided¹⁰², could still be regarded as constituting a breach of good faith and thus null and void.

98 Mark Augenblick and Alison B. Rousseau, "Force majeure in Tumultuous Times: Impracticability as the New Impossibility", 13 J. World Investment & Trade 59, 71. In the American case *SNB Farms, Inc. v. Swift & Co.*, Nos. C01-2077, C01-2078, C01-2080, 2003 U.S. Dist. LEXIS 2063 (N. D. Iowa Feb. 7, 2003), the court prevented the sellers from exercising their rights resulting from the occurrence of an event of force majeure because they did not comply with the notification requirements specified in the contract.

99 By implementing Council of Europe Directive 93/13/EC of 5 April 1993 on unfair terms in consumer contracts.

100 In Portugal, see DL no. 446/85 of 25 October.

101 Article 21(f) of the above DL.

102 Article 18(c) of the Decree-Law could be at issue, which means that such a clause would be absolutely prohibited.

MODEL FORCE MAJEURE CLAUSES

Below, we present two models of force majeure clauses. It is interesting to note that these two models provide widely differing solutions to some issues. This illustrates the importance of carefully analysing the provisions in each contract.

ICC FORCE MAJEURE CLAUSE 2003

The ICC has proposed a model force majeure clause for international commercial contracts. It sets out a definition of force majeure and its consequences for the contract.

Force majeure is defined by reference to a criterion of reasonableness. It is therefore not necessary for there to be an absolute impossibility, but rather that the fact could not reasonably be controlled, foreseen, avoided and overcome.

An illustrative list of force majeure events is provided. These include, among others, acts of authority whether lawful or unlawful, compliance with any law or governmental order, rule, regulation or direction, curfew restriction, expropriation, compulsory acquisition, seizure of works, requisition, nationalisation (paragraph d); acts of God, plagues and epidemics (paragraph e); general labour disturbance (paragraph g)). If the affected party proves the occurrence of one of these events, the event is presumed to be beyond its reasonable control and could not have been foreseen (the other party may rebut these presumptions). However, the affected party still has to prove that it could not have avoided or overcome its effects.

The ICC model covers events that occurred before the contract was made but were not known to the parties. It also covers events whose extent and impact were not known.

As to the consequences of the occurrence of a force majeure event, the affected party is released from the moment the event occurs, if the other party was promptly informed of its occurrence, or, if it was not, from the moment it was. However, the ICC model expressly provides that the affected party is obliged to mitigate the effects of the impediment.

These consequences apply only as long as the impediment lasts and the affected party is obliged to inform the other party when the impediment comes to an end. The affected party is relieved from any liability in damages or any other contractual remedy for breach of contract. If the force majeure event substantially deprives either or both of the contracting parties of what they were reasonably entitled to expect under the contract, the parties can terminate it and recover the value of any benefit they have provided to the other party in performing the contract in the meantime.

The clause proposed in the model contract known as the FIDIC Red Book also contains a definition of force majeure and establishes the consequences of its occurrence

THE INTERNATIONAL FEDERATION OF CONSULTING ENGINEERS (FIDIC) RED BOOK (1999)

The clause proposed in the model contract known as the FIDIC Red Book also contains a definition of force majeure and establishes the consequences of its occurrence.

The 1999 FIDIC Red Book proposes the following definition of force majeure: “an exceptional event or circumstance which: a) is beyond the party’s control; b) which the party could not reasonably have provided against before entering into the contract; c) having arisen, the party could not reasonably have avoided or overcome, and d) is not substantially attributable to the other Party.”

The model contract also includes an illustrative list of facts which may constitute circumstances of force majeure. The list includes war, hostilities, revolution, riot, disorder, strike or lockout by persons other than the party’s personnel and other employees of the contractor and the subcontractors, and natural disasters.

However, under to sub-clauses 8.4 and 8.5, an unpredictable shortage of labour or raw materials caused by an epidemic or government measure are not force majeure events. Nevertheless, they do give the right to an extension of the period to perform the obligations.

Like the ICC model, the FIDIC model covers events that occurred before the contract was concluded, but which were not known to the parties.

It is essential that the affected party promptly notifies the other party as soon as it becomes aware, or should have become aware, of the occurrence of the force majeure event. The party affected by the occurrence of the force majeure event can only benefit from its rights under it if/when the information is provided.

While the force majeure event lasts, the party affected will not be obliged to comply, although it is expressly obliged to mitigate the effects of the impediment. There will be an extension of the deadline for compliance corresponding to the time the contract is suspended, and the affected party is obliged to inform the other party of the end of the impediment.

The ICC model establishes that the right of termination exists when the event substantially deprives either or both of the contracting parties of what they were reasonably entitled to expect under the contract. In contrast, the FIDIC model uses an objective criterion which determines that either party may terminate the contract if the force majeure event causes a continuous delay of 84 days. Sub-Clause 19.6 provides that either party may terminate the contract if the substantial execution of the works is interrupted for a continuous period of 84 days for reasons of force majeure, or for multiple periods of up to 140 days in total.

Hardship clause

The hardship clause, like the force majeure clause, constitutes a departure from the principle *pacta sunt servanda*. This principle binds contractual parties to their obligations, even if there are changes in the circumstances on which the parties based their decision to contract. It also protects the interests of the party not affected by the supervening event.

This clause provides that the parties may amend the contract based on a “supervening change in the financial equilibrium of a transaction, which makes it more onerous for one of the parties to perform its obligations”,¹⁰³ thus allowing the contract to continue in force. The performance of the contract becomes difficult, but not impossible. Therefore, the purpose of this clause is to allow a degree of flexibility and to optimise the performance of the contract.

As stated above, the hardship clause makes it possible to amend the contract. This distinguishes it from the force majeure clause, which provides for the suspension of the parties’ obligations or the termination of the contract at the time of an eligible event, depending on the wording. Thus, while the occurrence of a force majeure event results in the suspension of the obligations of both parties or the termination of the contract, the hardship clause allows for renegotiation.

Depending on the terms of the contract in question and the applicable law, this clause may or may not take effect automatically.

The hardship clause
makes it possible to
amend the contract.
This distinguishes
it from the force
majeure clause.

MODEL HARDSHIP CLAUSES

ICC

The ICC recommends the adoption of its model hardship clause (“ICC Hardship Clause”). Under this clause, a party may ask a court or arbitration tribunal to adapt the contractual obligations so as to restore a balance or to terminate the contract¹⁰⁴.

It states that “A party to a contract is bound to perform its contractual duties even if events have rendered performance more onerous than could reasonably have been anticipated at the time of the conclusion of the contract.”

103 V. VICENTE, DÁRIO MOURA, *Direito Comparado: (Obligations)*, vol. II, Almedina, 2017, p. 5. 248

104 [ICC Force majeure Hardship Clauses - March 2020](#) p. 5

For this clause to apply, the affected party must prove that (a) performance of its contractual obligations has become unreasonably onerous because of an event beyond its reasonable control and it is unreasonable to expect that the party would have taken it into account at the time the contract is signed; and (b) it could not reasonably have avoided or overcome the event or its consequences. In this case, the parties are obliged, within a reasonable time after invoking this clause, to negotiate alternative contractual terms which reasonably overcome the consequences of the event.

Therefore, sub-section 3 of the model clause gives two options: the parties can either terminate the contract themselves or ask a judge or arbitrator to adapt or terminate it.¹⁰⁵

PICC

The UNIDROIT Principles of International Commercial Contracts provide for the hardship mechanism in article 6.2.1.¹⁰⁶ According to the PICC, “*There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished* and:

- the events occur or become known to the disadvantaged party after the conclusion of the contract;
- the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
- the events are beyond the control of the disadvantaged party; and
- the risk of the events was not assumed by the disadvantaged party”¹⁰⁷.

Like the ICC, the PICC gives the affected party the right to ask the other party to renegotiate the original terms of the contract to adapt them to the change of circumstances. Even if the affected party does not lose the right to request renegotiation of the contract, it should do so as soon as possible, in order to avoid making it more difficult to successfully argue that the change was indeed highly disruptive to compliance.

The parties generally have a degree of contractual freedom to define the requirements that define a potential material adverse change.

If the parties do not reach an agreement within a reasonable time,¹⁰⁸ either party may turn to the court. The court may then terminate the contract, on a date and on conditions to be set, or adapt it to restore the balance.¹⁰⁹

Material adverse change clause

The clause¹¹⁰ usually called a material adverse change clause is often used in commercial contracts, in particular, in the context of corporate acquisitions. It aims to give the buyer the right to withdraw from the purchase before completion if events occur that are detrimental to the target company.

In the context of loans, the purpose of material adverse change clauses is to enable the lender to default on the contract if there is an adverse change in the borrower’s situation.

Although the use of material adverse change clauses is frequent in commercial transactions, there are no known model clauses

¹⁰⁵ Any party may request that the contract be adapted or terminated accordingly.

¹⁰⁶ For more information on the application of these Principles, see footnote 92.

¹⁰⁷ See article 6.2.2.

¹⁰⁸ The PICC do not define a reasonable period for this purpose.

¹⁰⁹ See article 6.2.3.

¹¹⁰ See *Grupo Hotelero Urvasco SA v Carey Value Added SL and another* [2013] EWHC 1039 (Comm) and *Cukurova Finance International Limited and another v Alfa Telecom Turkey Limited* [2013] UKPC2



This clause usually gives the lender (in the context of financial contracts) or the buyer (in commercial contracts) the right to terminate the contract if an eligible event occurs. The parties generally have a degree of contractual freedom to define the requirements that define a potential material adverse change. If they do not do so, the court will determine on a case-by-case basis whether an eligible event has in fact occurred. The cases below are some examples.

In *IBP, Inc. v. Tyson Foods*,¹¹¹ the company Tyson Foods intended to terminate its merger agreement with IBP. IBP had low incomes for one six-month period. For this reason, Tyson Foods cited a material adverse change clause in the contract to request its termination. It argued that IBP's low income constituted a significant adverse change under the contract. The court rejected this argument. Under this judgment, material adverse change clauses serve to protect buyers from the occurrence of "unknown facts that substantially threaten the overall income potential of the target company significantly in terms of duration".¹¹² As such, a contractor who that is aware of cyclical factors that could affect the target company's income cannot use a material adverse change clause to request the termination of a contract.

In *Pan Am Corp. v Delta Air Lines Inc.*,¹¹³ Pan Am and Delta negotiated an investment by Delta in Pan AM II - a company formed after the restructuring of Pan Am. One condition of the investment was that "*no material adverse change in business, financial position, results of operations or prospects*" would occur. Before the investment was completed, sales decreased, expenses increased and revenue forecasts fell sharply. The court found that those results reflected a material adverse change and, therefore, it held that the deal had not been concluded.

In the United Kingdom, in the case of *Hotelero Urvasco SA v Carey Value Added*¹¹⁴, the court recognised the lender's right to terminate the share purchase agreement and refuse to make further advances under a loan agreement which contained a material adverse change clause, since an adverse change in the borrower's financial situation had occurred, which is eligible under the clause. The High Court decided that a change of circumstances can only be significant if it affects a party's ability to perform its obligations under the contract. It also decided that a lender cannot trigger a default on the basis of circumstances it was aware of at the beginning of the negotiation.

111 *IBP, Inc. v Tyson Foods, Inc. et al.*, C.A. No. 18373 (Del. Ch. 18 June 2001)

112 *Ibidem*, para. 68

113 *Pan Am Corp. v Delta Air Lines Inc.*, 175 B.R. 438, 514 (S.D.N.Y. 1994).

114 *Grupo Hotelero Urvasco SA v Carey Value Added SL & Anor* [2013] EWHC 1039 (Comm) (26 April 2013).

4. Investment arbitration

The measures adopted by individual states in the context of the pandemic may affect contracts concluded under bilateral investment treaties (or BITs). This raises potential disputes between foreign investors and states.

Indeed, states have adopted various measures to mitigate the spread of the disease, which will have an economic impact that is still difficult to predict. As the pandemic developed, states were forced to take decisions that directly affected companies and limited their activity, potentially jeopardising their investments and the bases on which they were made.

It is anticipated that foreign investors will want to litigate against states (using investment arbitrations). This calls into question the measures taken by states to manage the pandemic. The arguments for action and for defence on this matter will therefore be used and we will examine them below.

Mechanisms provided for in BITs

The identification of the foreign investor's claim and the arguments underlying it require an analysis of (i) the BIT under which the investment was made and (ii) the contractual clause by which the parties specifically agreed to be bound.

GENERAL TREATMENT STANDARDS

BITs usually contain rules of treatment that bind states.

BITs may set out standards or rules that limit state action. These include fair and equitable treatment and full protection and security. They usually include a principle of non-discrimination against foreign investors, which prevents them from being treated unfavourably compared to domestic investors.

The rules on fair and equitable treatment of the foreign investor (both procedural and substantive) are often invoked in arbitral investment disputes and the degree of exigency associated with compliance with those rules has been the subject of different interpretations.

It is important to note that the measures adopted by a state may not, in principle, result in discriminatory or unfavourable treatment of the foreign investor in relation to domestic investors when they are in the same circumstances. If they do, such measures will be a breach of the BIT and, consequently, of the contract concluded under it.

Through the standard of full protection and security, states undertake to adopt the measures necessary to ensure the protection and security of the investor and its investment in the country in question. In the context of the pandemic, various scenarios may be considered where non-compliance with this standard becomes relevant. These include cases in which the state has refrained from taking the measures necessary to contain and limit the spread of the virus – or has done so too late and then resorts to more serious measures than would have been necessary – thereby affecting the investments made.

The measures adopted by individual states in the context of the pandemic may affect contracts concluded under bilateral investment treaties

EXPROPRIATION

Some of the measures adopted by states in the context of a pandemic may consist of direct or indirect expropriation (for example, when the state adopts measures that make it possible to acquire effective control of the investment or to affect its value). In these situations, the investor is deprived (directly or indirectly) of the ownership, effective control or benefits that it would normally enjoy. We refer, for example, to hypotheses in which the state intervenes or imposes on private individuals (clinics, hospitals, companies manufacturing medical or personal protective equipment, etc.) certain directives that limit their freedom of management.

If appropriate and fair compensation is not paid, the investor can bring a claim against the state. The same will happen, in cases of indirect expropriation, if the state intervention is prolonged unreasonably.

Among other things, the arbitral tribunal will take into account the specific measures adopted, and their effects and purposes.

EXCEPTIONS

BITs may provide for exceptions to the requirement that states comply with the obligations set out in the BITs. This is particularly so when there are situations in which fulfilment of those obligations is incompatible with policies intended to protect values and interests considered essential. The provision of these exceptions ensures that the obligations contained in an BIT do not limit the ability of the state to adopt measures necessary to protect essential interests and values.

Thus, the state may be allowed to adopt exceptional measures when they are intended to protect, for example, public health or security requirements, without them constituting a breach of the treaty and, consequently, providing the grounds for a potential dispute.

Faced with the pandemic, it is anticipated that some states may justify non-compliance with obligations based on the need to adopt measures to ensure the protection of human life and public health.

The provision
of these exceptions
ensures that the
obligations contained
in an BIT do not
limit the ability of
the state to adopt
measures necessary
to protect essential
interests and values.

Nevertheless, the scope of application of the exception will depend on the interpretation of the rule that provides for it. This may be more or less demanding depending on the requirements established in it.

Furthermore, it will be for the courts to assess whether: (i) the measures were discriminatory, (ii) the motives underlying them were in fact those declared (and not cunning ways of achieving ends which, in “normal” circumstances, it could not have achieved), (iii) the declared ends could not have been achieved with alternative measures that ensured both the public interest objectives and compliance with international obligations, and (iv) the actual measures were reasonable in light of the purposes they were intended to protect.

Force majeure is recognised internationally as a general principle of law and it applies in international law and, specifically, in international arbitration.

Mechanisms of international law

Customary international law provides for a set of rules that can be invoked in disputes between foreign investors and states. Special reference is made to the rules on the liability of states in the United Nations Commission on International Law.

It is anticipated that, in potential disputes between foreign investors and states arising from the pandemic and because of the enactment of measures relating to it, states will make use of these rules to escape liability.

We consider three circumstances: force majeure, distress and necessity.

FORCE MAJEURE

Force majeure is recognised internationally as a general principle of law and it applies in international law and, specifically, in international arbitration (commercial or investment).

In order for a state to avoid liability on the grounds of force majeure, it must claim and demonstrate that all of the following requirements have been met:



- A force majeure event (the result of an “irresistible force” or an unforeseeable event) has been established;
- The force majeure event must be beyond the control of the state;
- In view of the circumstances, it must become materially impossible to perform the obligation (not just more difficult or costly);
- The situation of force majeure cannot be due to the conduct of the state invoking it (either individually or in combination with other factors);
- The state must not have assumed the risk of the occurrence of the force majeure event.

The finding of force majeure only justifies failure to perform the obligation during the period in which the underlying circumstance continues.

This instrument differs from the others (distress and necessity) because, in the case of force majeure, the conduct of the state is involuntary or, at least, involves no element of freedom of choice. This is one of the requirements that makes it difficult for the state to apply the force majeure rules practice.

It is accepted that the pandemic can be considered a force majeure event. This is not due to the unpredictability of its occurrence, because, in many countries, the spread occurred after the outbreak was known. However, it can be considered a force majeure event because of its “irresistible force”, as, at least in the vast majority of cases, states could not have done anything to prevent the virus from reaching their territory.

Moreover, considering that the application of the force majeure rules depends on meeting demanding requirements, it has been particularly difficult for states to have their claim recognised on this basis. This difficulty is expected to persist in cases relating to the pandemic. In fact, although the pandemic can be considered as an unforeseeable event or an “irresistible force” (i.e., force majeure), the state still has to demonstrate that it was in a situation of material impossibility to fulfil the obligations by which it was bound. However, meeting this requirement seems to be particularly complex because, in most situations, compliance will prove particularly costly but not impossible. Therefore, the state will still have freedom of choice and, consequently, the possibility of complying (even if this proves particularly difficult). Moreover, the courts have interpreted this concept differently: some courts require absolute material impossibility, while others believe the concepts do not coincide.

However, whether or not this defence by the state is justified or unfounded will depend on the specific obligation/breach in question and the circumstances surrounding the case.

DISTRESS (EXTREME DANGER)

In order for a state to escape responsibility based on distress, it must claim and demonstrate that all of the following requirements have been met:

- The existence of a threat to life;
- The existence of a special relationship between the entity that does the act – a state body or an individual whose acts are imputed to the state – and the holder of the right to be protected;
- Absence of a reasonable alternative means of dealing with the threat;
- The situation of distress cannot be due to the conduct of the state that invokes it (either considered individually or in combination with other factors);
- The act must be proportionate. In other words, it must not lead to a greater risk or threat than that which is intended to be safeguarded.

It is therefore a question of situations in which the entity that does the act or the persons under its responsibility are in great danger, and there is no other reasonable way – other than the breach of an obligation – to protect and save those lives.

The finding of force majeure only justifies failure to perform the obligation during the period in which the underlying circumstance continues.

The requirement identified in (i) will, in principle, be met, because the pandemic could amount to a threat to the lives of the citizens of each country.

The second requirement – the existence of a “special relationship” between the state body or agent and the people in danger – is intended to circumscribe the application of distress by excluding broader emergency situations. Doubts therefore arise as to the applicability of distress to the facts we are considering here. In fact, distress has essentially been applied in cases where aircraft or ships in distress enter the territory of another state. However, it has also been considered in cases where the state intervenes for humanitarian reasons to guarantee the lives of its representatives abroad. In such cases, there was an undeniable special relationship between the perpetrator of the breach and the life to be protected.

However, some believe it is arguable that the lives of citizens specifically depend on the action of the government (if it alone has the power to approve the measures to achieve the desired end). This would be sufficient to demonstrate the special relationship which is a requirement for distress.

Moreover, the origin of a defence based on this ground and, specifically, the fulfilment of the other requirements, depends on an analysis of the measures adopted (to assess their reasonableness), their impact (to assess their effects) and the other circumstances surrounding them.

We admit that recourse to this mechanism may be beset with particular difficulties. This is not only because of the demanding requirements and the challenge in meeting them, but also because the cases to which it has been applied are factually very different from those potentially envisaged in the context of a pandemic. However, it is expressly acknowledged that its application is not limited to these cases.

NECESSITY

This mechanism has been invoked and discussed in investment arbitrations that arose in the context of the financial crisis in Argentina. Several authors have argued that it is the customary international law instrument best suited to the defence of the state in investment disputes arising from the adoption of measures to combat the pandemic.

For a state to be able to escape its responsibility on the grounds of necessity, it must claim and demonstrate that all of the following requirements have been met:

- The act of the state is the only means of ensuring the protection of an essential interest that is in a situation of serious and imminent danger;

For a state to be able to escape its responsibility on the grounds of necessity, it must claim and demonstrate that several have been met.

- The act of the state cannot seriously compromise another essential interest (namely, the international community);
- The possibility of recourse to this mechanism cannot have been ruled out in the specific case;
- The state must not have contributed to the situation of necessity.

This instrument is intended to safeguard situations in which the state is obliged to breach an international obligation to ensure an essential interest that is threatened by a serious and imminent danger/risk.

It differs from force majeure in that it requires the voluntary conduct of the state and distress. This is because it is not restricted to a threat to the lives of individuals who are under the responsibility of a state agent or body, but to a serious threat to essential interests (either of the state or of the international community).

Given what is already known, the emergence and development of the pandemic represented (and represent) a serious and imminent danger. It is a threat to the health, life and well-being of populations and to the normal functioning of public services. These interests must be classified as essential and this has, in fact, already been recognised in arbitral investment jurisprudence.

Moreover, it is also expected that the protection of these interests (health, life and welfare of the population, as well as the normal functioning of public services) will take precedence over the interests of foreign investors and their states.

The requirement it is anticipated will be particularly difficult for the state to meet is that the measure adopted by it must be the only one capable of safeguarding the (essential) interest it is intended to protect. That requirement will oblige the court – placing itself in the position the decision-maker was in and taking into account the knowledge available to it – to assess (i) whether or not there were potential alternative measures, (ii) whether or not those measures would make it possible to achieve the same result without the state's obligations towards the foreign investor being infringed, (iii) regardless of whether they were more costly or inconvenient.

Doubts also arise whether the analysis of this requirement should be made by reference to the measure that is actually being analysed (having determined the breach of obligation by the state) or whether the measure should be seen as part of a package of measures. Indeed, many measures, taken individually, may not pass this test. Nevertheless, the package of measures as a whole could already be seen as the only way to prevent the spread of the disease and to mitigate its effects.

Furthermore, any state measure that goes beyond what is strictly necessary to safeguard the interest to be protected will not be covered by the protection afforded by the situation of necessity.

Finally, that ground will be dismissed if the court concludes that the state contributed to the “situation of necessity”. A number of difficulties arise here, in particular in defining the scope. The question arises as to whether that argument should be dismissed where, for example, the state that invokes it has reduced investment in the national health system, thus weakening it and limiting its response to the pandemic. The same question arises when the state has been particularly slow to adopt measures to mitigate the spread of the virus.

The courts have placed different interpretations on the requirement of the state's contribution to the situation of necessity. Some use a purely causal criterion while others interpret it in a more restrictive way and also require a notion of guilt. It is understood that, to assess whether this criterion has been met, a material contribution must be made and not merely an incidental or peripheral one. Nevertheless, it is recognised that the vagueness of the concept raises particular difficulties regarding the potential outcome of a defence based on this situation.

It is also important to remember that this assumption is more restricted than the one which, in parallel, is provided for both force majeure and distress. In fact, the application of force majeure and distress is excluded when the situation was caused by the state. In the case of necessity, it is sufficient for the state to have contributed to the situation of necessity for its application to be excluded.

Once again, the difficulty of finding that the exacting requirements on which the application of necessity depends is recognised and anticipated.

Concluding remarks

Given the exceptional nature of the current situation, it is difficult to draw a parallel with any other situation that has ever been experienced. Nevertheless, it is useful to look at international experience in the context of other crises, such as the world crisis of 2007-2008, the economic crisis in Argentina in 2001, and the Arab Spring.

BITs provide foreign investors with several defence mechanisms that could be considered in potential investment disputes. However, it should be noted that, in the value judgement made on whether the foreign investor's claim succeeds or fails, it may also be relevant to look at when the investment was made. In other words, one must ask whether it comes before or after the pandemic and, consequently, whether the measures taken by the state and the potential consequences of an economic and financial crisis can be considered as being part of the investor's commercial risk.

Furthermore, although it is difficult (or even impossible) to define a pattern of action – first of all, because the factual requirements of arbitration proceedings are very diverse – previous experience shows that states have particular difficulties in prevailing on the grounds to which we alluded. In fact, the state's defence mechanisms arising from customary international law provide for very demanding requirements for them to apply. Moreover, these requirements have not been consistently interpreted by the different courts (even in the face of parallel factual circumstances). Naturally, this generates a great deal of uncertainty (both for investors and for the state) as to whether or not the possible origin of these regimes.

Given the exceptional nature of the current situation, it is difficult to draw a parallel with any other situation that has ever been experienced.

About PLMJ

We are a law firm based in Portugal that combines a full-service with all the mastery and skill of legal craftsmanship.

We have a genuine enthusiasm for overcoming the impossible that often takes us down the “road less travelled” and transforms old certainties into new disruptions. For more than 50 years, our bold and transformative approach has translated into real solutions that respect the requirements of the law and effectively defend our clients’ interests.

We focus on specialisation and our lawyers have the academic and professional experience needed to be essential team-mates in the lives and businesses of our clients and partners.

We know our clients, share their risks and support their decisions by giving our opinions and proposing strategic solutions that bring them added value. This has been and will always be our greatest commitment.

About the Dispute resolution team

We support our clients in complex disputes that are critical to their businesses and reputations.

Our dispute resolution practice has a highly specialised team that handles all aspects of litigation, arbitration and other ADR methods. The team deals with disputes of the most varied nature, representing clients from a wide range of sectors.

Our multidisciplinary approach allows us to have a team of specialists that combines knowledge in areas such as competition, banking, finance and capital markets, with solid experience in litigation and arbitration.

KEY CONTACT



**Mariana
França Gouveia**

Partner in the
Dispute Resolution practice

(+351) 211 592 507
mariana.francagouveia@plmj.pt



**Catarina
Félix Pericão**

Associate in the
Dispute Resolution practice

(+351) 213 197 350
catarina.felixpericao@plmj.pt



**Jeice
Filipe**

Trainee in the
Dispute Resolution practice

(+351) 213 197 440
jeice.filipe@plmj.pt



**Joana Ribeiro
de Faria**

Trainee in the
Dispute Resolution practice

(+351) 213 197 463
joana.ribeirofaria@plmj.pt

Recommended area

Chambers Europe
Chambers Global
The Legal 500

25+

International awards

TOP 50

Most innovative
law firms in Europe
Financial Times – Innovative
Lawyers Awards



