

CORONAVIRUS: MANAGING RISK IN COMMERCIAL CONTRACTS – THE GERMAN LAW PERSPECTIVE

The Covid-19 pandemic is affecting people and businesses on a global scale. Despite significant governmental actions around the globe, the virus continues to spread, affecting business models and disrupting supply chains. Companies and their directors have to manage the threat posed by the virus not only with a view to current commercial relationships that may be at risk from the virus, but also regarding protections required in transactions that are being negotiated now and in the future. In this briefing, we look at German law issues arising from the current events.

The economic and financial threat posed by COVID-19 (SARS-CoV-2) passed largely under the radar in the first couple of months of the outbreak. However, as the virus continues to spread, the arising risks must be reassessed, including the increased challenges for people, economies and businesses alike. Central governments, central banks, and other governmental agencies are putting in place plans as to how they will respond in various scenarios. Most of Continental Europe is already subject to a lockdown with far reaching restrictions on travel and business activities to contain the risks arising from COVID-19. The EU and countries around the world have closed their borders to travellers. The German Chancellor Angela Merkel recently warned of a worst case scenario that two out of three Germans eventually might become infected.

Governments plan at a macro-level economically. Businesses operate at a micro-level, and cannot expect governments to do their planning for them. Many businesses have, quite properly, started their planning process by laying down procedures designed to protect their staff. These might, for example, include compulsory home office use, bans on business (or even personal) travel to affected areas, attendance at large events and self-quarantine procedures.

Measures of this sort are important, but they are not enough. Companies need to consider how the spread of the virus may affect the conduct of their underlying business, their supply chains and what they can do about it. This is not easy – there is huge uncertainty – but uncertainty does not absolve directors of the need to try to protect their companies and address identified

Key issues

- The coronavirus pandemic affects economies, businesses and disrupts supply chains.
- Under German law, commercial contracts may offer relief to affected parties, e.g. in events of force majeure, a right to adapt or terminate the agreement (§§ 313, 314 BGB), or factual/legal impossibility (§ 275 BGB).
- Risks must be carefully assessed on a case-by-case basis in view of the available legal remedies in order to adequately and effectively manage potential exposure.

risks as best they can. Regulated industries may also need to consider their regulators' requirements, such as resilience.

Future transactions

Perhaps the easiest area is transactions being negotiated now. How might COVID-19 affect your company's ability to perform its obligations? For example, are you dependent on suppliers who might themselves be affected, or is the risk confined to the availability of staff? Is the risk one of timing (you will be able to perform, perhaps later than intended but not affecting the viability of the transaction as a whole), or is the risk more fundamental than that?

Once the risks have been identified, the next step is to consider what protections are required in the contract for the transaction at hand. For example, if the potential is for delay, at what point should delay have financial consequences and when should a party have the right to pull out altogether? If expedited shipping is required to make up for production lost by a governmental shut-down, who bears the increased costs? How can risks be mitigated and addressed throughout the supply chain?

If you are thinking about this, your counterparties will (or should be) doing so, too. How will they be affected, and what protections will they want?

Past transactions

Talk to your counterparty

For transactions already agreed, the most obvious point is to discuss with your counterparty the potential impact of the virus. A discussion in advance as to what contingencies the parties might need to build in, even if the risk seems remote at the moment, is likely to be preferable to an unpleasant surprise later on. What comfort do you need, or can you get, that your counterparty will be able to perform its side of the bargain?

What does the contract say?

The agreement covering the transaction is likely to be the starting point.

Force majeure

Does the contract contain a force majeure clause? If so, the applicability will depend upon its specific drafting. When a pandemic is not explicitly mentioned, the clause will have to be analysed, whether COVID-19 and related implications nonetheless fall within the scope of the clause. If COVID-19 can be classified as a force majeure event, the affirmation or rejection of this in an individual case may require a considerable amount of substantiation. To this end, the assessment of governmental authorities or the WHO may be relied on as an indication. The force majeure clause may require (reasonable) steps to be taken to mitigate the consequences of the virus and, ultimately, it may allow suspension of performance or the termination of the contract. Force majeure clauses invariably require a link between the event and the inability to perform the contract – COVID-19 cannot be used as an excuse to walk away from an onerous contract. If a party does decide to rely on a force majeure clause, it would be wise to ensure that it retains the evidence upon which it acted (e.g. copies of governmental announcements).

It is generally advisable to screen existing contracts for areas of yet unforeseen consequences of the COVID-19 pandemic, e.g regarding guaranteed delivery dates or the allocation of transport costs.

Adaptation and termination of contract

Further, German law offers means to adapt or terminate existing contracts (§§ 313, 314 BGB), when the factual basis, on which the contract has been agreed upon changes significantly and unreasonably alters the equilibrium of the contract. Whether an adjustment or termination of the contract is possible depends on what reasonably can be expected by a party on a case-by-case basis, and in consideration of the contractual allocation of risk.

Impossibility

Particularly governmental restrictions may render a performance impossible under certain circumstances. According to § 275 BGB, an obligation to perform ceases if and to the extent the performance is impossible, even if the performance is only temporarily hindered. The impossibility can be of objective, subjective, and legal nature (i.e. export/import bans). A party may even refuse performance if the fulfilment is grossly disproportionate, § 275 par. 2 BGB. Below the threshold of (time-related) impossibility, liability for delay is a potential risk, especially if notification obligations were not complied with.

A similar principle is stipulated by Art. 79 CISG, which have been acknowledged by courts to apply in events of epidemics. Which rules apply in each case is therefore of utmost importance.

Significance of Time

The spread of COVID-19 will be an event beyond the parties' control, but it may not have been outside the parties' contemplation if the contract was entered into in, say, February 2020. Therefore the predictability and foreseeability of any implications regarding COVID-19 may impact the rights and duties, as well as subsequent claims for damages.

Changes in law

Some contracts may also protect parties against changes of law, and allow claims for additional time and unforeseen costs. COVID-19 controls imposed by law may fall within this type of clause.

Material Adverse Change (MAC)

Financial contracts often contain MAC clauses that allow a financial institution to call an event of default or refuse to perform if the counterparty is subject to a material adverse change. Again, whether and how this applies will depend upon the wording, but clauses usually pose the question of whether an event has had, or will have, a material effect on the ability of a party to perform its obligations under the contract.

Notices

Whether a contract contains a force majeure, change in law, a MAC clause or another applicable clause, it may require notice to be given to the other party, perhaps within a certain period of the event in question occurring. Notice provisions must be complied with strictly. Even beyond an explicit duty to inform, contact can be advisable to mitigate risks. In any case, it is highly recommended to document any exchange of information.

Limitations on liability

Even if the contract has nothing direct to say about COVID-19, the contract may contain limitations on, or exclusions of, liability. Clauses may cap, limit, or exclude a party's ability to recover from a counterparty (or its obligation to pay to a counterparty) losses caused by COVID-19 complications.

General issues

Companies will want to check what insurance cover they have that might cover COVID-19. If a company does have insurance cover, the policy is likely to contain notification requirements, which must be complied with strictly. Insurance companies are seldom tolerant of breach even of the smallest of small print.

If the worst comes to the worst, how are disputes to be handled? Who should handle communications? When should an edict be sent to discourage employees from putting finger to a keyboard in a manner that might be unhelpful? Ultimately, what are the relevant dispute resolution means, and is it prudent to be the first into court in order, for example, to forestall the counterparty taking proceedings in an unacceptable venue?

Conclusion

COVID-19's impact on economies and businesses generally, or on commercial transactions in particular is not easy to predict. This does not, however, absolve company directors of the need to plan and address risk adequately. The worst may not happen, but those who come out best after a catastrophe are inevitably those who have thought about it most in advance.

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