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CLIENT ALERT

COVID-19: THE IMPACT OF THE EMERGENCY SITUATION ON CONTRACTUAL OBLIGATIONS – SOME TAKEWAYS FOR COMPANIES AND THEIR MANAGEMENT BODIES

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Francesca Petronio | Fabio Cozzi | Irene Saura

Doing Business in Times of Emergency – The on-going pandemia and the relevant extraordinary restrictive measures are having a disruptive effect on contracts performance, exposing businesses to potential conflicts and significant risks. Contractual remedies and applicable law may exclude liability, but companies should act timely and directors diligently. Here an overview from an Italian law perspective and some takeaways for companies and their management bodies.

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In the context of the emergency situation deriving from the spread of COVID-19, the Italian Government has adopted a series of restrictive measures limiting the freedom of movement of people within the Italian territory,[1] suspending several businesses activities and definitely impacting on the assets of contracts and agreements. In this situation, not only the pandemic *per se*, but also the concurrent economic and legislative scenario may both – as it seems they are effectively doing – impact on the ability of the parties to meet contractual obligations, making it urgent to intervene with legal remedies to face the contingent situation.

In particular, as a consequence of both the health emergency and the restrictive measures adopted, debtors may not be able to fulfil their obligations, or to do it within the agreed terms of the fulfilment and creditors themselves may no longer be able to receive the performance or even no longer be interested in receiving it.

I. How Does The Pandemic Affect Contracts? Potential Triggering Of *Force Majeure* Clauses

On the one side, the declaration by the World Health Organization of the current emergency as pandemic situation, may be relevant in cases where contracts do include clauses expressly or implicitly referring to pandemic.[2] It may be the case of *force majeure* clauses, allowing a party to suspend the execution of the obligations or to terminate the contract, without being held liable towards the counterparty, in case of exceptional events.

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[1] In particular, Law Decree No. 18/2020 containing "*measures aimed at strengthening the National Healthcare Service and supporting families, workers and businesses affected by the epidemiological emergency of Covid-19*"and Law Decree dated 22nd March 2020.

[2] This may be the case of insurance policies, that generally do not cover consequences deriving from pandemic situations.

Contracts may specifically define what has to be considered an event of *force majeure*, or may adopt a more general definition, to be then interpreted according to the law governing the contract. Italian law does not provide for specific provisions regulating "*force majeure*"; according to case law, the *force majeure* is a particular impediment – absolute, extraordinary and unforeseeable – to a certain action or activity, so that the creditor's effort cannot overcome such an impediment. In particular, case law requires:

(i) The unpredictability of the event at the time of the conclusion of the agreement;

(ii) That the event is beyond the control of the parties; and

(iii) That the event effectively prevents the execution of the agreement or of the obligations.

Given the fact that the *force majeure* is to be intended as absolute, extraordinary and unforeseeable, it could be said that the pandemic may be effectively conceived as a *force majeure* cause.

According to case law, in fact, epidemic is a contagious disease, which can be identified on the base of (i) the rapidity of spread; (ii) the transmission to an undefined, and still large, number of people; (iii) the spread on a wide part of the territory.[3]

Furthermore, there are international instruments which provide for a definition of *force majeure*: it is the case of the Vienna Convention on Contracts for the International Sale of Goods – requiring that the event is unforeseeable, beyond the control of the obligor, and insurmountable – and the ICC *Force Majeure* Clause issued by the International Chamber of Commerce in 2003 – which lists also examples of events which may be considered as *force majeure*, including epidemics.

Besides *force majeure* clauses, M&A agreements usually include the so-called "material adverse change" or "material adverse effect" clauses, providing that, before the closing, the buyer may walk away from the acquisition in case of any event materially and adversely impacting on the operations, assets, profits, etc., of the target company. Although such clauses may considerably vary in their content, it is usually required that the event at issue was not foreseen neither foreseeable in the moment of the conclusion of the acquisition agreement.

Therefore, in case of contracts or agreements including such clauses, it shall be considered whether the pandemic situation has been expressly taken into consideration by the parties in their agreement, in which terms and with which legal consequences. In this context it would likely be a point of legal discussion when this situation became "foreseeable".

It shall be noted that, regardless of the presence of such clauses, the pandemic may make it objectively impossible or excessively onerous to perform or receive an obligation: in such a case, the below listed remedies provided for by Italian law may also be available.

II. How Do The Restrictive Measures Affect Contracts? Remedies Under Italian Law

On the other side, by limiting the freedom of movement and prohibiting most of the commercial activities (unless those considered as "essential"), the adopted legislative measures may practically imply a concrete obstacle, physical or legal, to fulfil the obligations undertaken before the COVID

[3] Court of Savona, 06/02/2008.

outbreak: this is the effect of the so called "*factum principis*" which occurs in case legislative provisions or regulations make it objectively impossible to fulfil an obligation.

In such context, parties to contracts may have to face the following situations:

(i) **Definitive impossibility of performing**: whether the obligor finds itself in the objective and absolute impossibility of performance, for reasons that go beyond its own control,4 it may invoke the termination of the contract (Article 1256 Italian Civil Code, "CC") and consequently, it will not be held liable for non-performance (Article 1218 CC); at the same time, the obligor may not request the obligation of the counterparty, and it shall also return the obligation eventually already performed by the counterparty (Article 1463 CC);

(ii) **Temporary impossibility of performing**: whether the obligor finds itself in a temporary impossibility of performance, it may request a suspension of the contract (Article 1256 CC, para. 2), without incurring in liability for the delay in performance;

(iii) **Excessive burdensome obligation**: it may also happen that, even if the obligation itself is still possible, its performance would amount to an excessive burdensome obligation. In such cases, the party may request the termination of the contract,5 proving that such "excessive burdensomeness" (assessed on an objective basis, and not merely consisting in a difficulty of the performance) derives from extraordinary and unforeseeable events. With this regard, according to Italian case law,6 the extraordinary nature of the events shall be assessed on the base of measurable elements (in particular, the frequency by which the event occurs, the extent of the impact of the event, or its intensity), while the unpredictability of the event shall be assessed in terms of capacity of the parties to the contract to predict such an event. The relevant evaluation shall be conducted on the basis of the specific circumstances in which the contract was concluded, as well as on the professional status of the parties, and the business sector involved;

(iv) **Supervening lack of interest in receiving the obligation**: it may even happen that, during the temporary impossibility of performance invoked by the debtor (see above, point (ii)), the creditor has no longer interest in receiving the performance by the debtor; in such cases, the termination of the contract may assist (Article 1256, para. 3);

(v) **Impossibility to receive the obligation**: such hypothesis is not expressly regulated by Italian law; however, case law[7] admits that the creditor may be unable – as the debtor is unable to perform – to receive the obligation, or may anyway lack interest in receiving it, due to circumstances not attributable to the creditor's conduct; in such cases, the creditor may invoke the termination of the contract, which is no longer suitable to reach its ultimate scope (i.e. the so-called "*causa in concreto*" is missing).

III. Claim For Breach Of Contract And Damage Compensation

As seen above, the debtors who is no longer able to perform the contract due to the exceptional restrictive measures adopted by the Italian Government, may trigger the relevant contractual

[4] As required by case law, see for instance Court of Reggio Calabria, 27/11/2019, No. 1584; Court of Appeal of Bari, 25/11/2019, No. 2462.
[5] Unless the excessive burdensomeness falls within the normal contractual risk. See Article 1467 of the Italian Civil Code.
[6] Court of Rome, 13/04/2017, No. 7407; Court of Cassation, 19/10/2006, No. 2239; Court of Cassation, 23/02/2001, No. 2661.
[7] Court of Cassation, 29/03/2019, No. 8766; Court of Cassation, 10/07/2018, No. 18047.

clause, if any, or invoke one the briefly described legal remedies. In addition to that, and to support Courts in the relevant factual evaluation, the Decree[8] expressly provides that the compliance with the restrictive measures is always taken into consideration whether the debtor is sued for non-performance or delay in performance, and for compensation of damages and/or the payment of penalties provided for in the contract.

IV. Final Remarks And Takeaways For Companies And Their Management Bodies

On the basis of the above, it shall be considered that either the pandemic *per se* or the legislative measures enacted may cause the impossibility of fulfilling the undertaken obligations, or otherwise make it excessively difficult. Should this be the case, either contractual remedies (such as specific clauses) or remedies provided by law may assist the parties.

For the time being, companies facing difficulties in performing the contract should carefully consider the available remedies and board of directors may need to evaluate quickly how to act to take appropriate steps, among which we highlight the following:

(i) Review the contracts to analyze clauses addressing force majeure, impossibility, hardship etc. to seek guidance and properly undertake the necessary steps. It is also advisable not to underestimate the possible weight of general clauses (e.g. referring to good faith, etc.) which may be of use in this situation.

(ii) Review the law governing the contract. Contract clauses may not specifically address pandemic, may not be clear, and in any case they need to be interpreted. Seek advice to understand how the relevant clause would be interpreted by the competent Court in case of future judicial review (or in case of arbitral proceedings).

(iii) If no contractual clauses address the issue, the law applicable to the contract will likely provide for remedies. As seen above, Italian law provides for remedies which may apply in the current scenario.

(iv) Carefully evaluate the impact of the current emergency to the contract. Evaluate the chance to renegotiate the contractual terms. If so, make sure that all changes are properly documented in compliance with the contract.

(v) In case of no room to renegotiate the contract with subsequent decision to terminate the contract on the basis of the applicable force majeure clause, or applicable statutory remedy, the company should act timely, sending a written, detailed, notice to the counterparty, explaining how the COVID-19 emergency has affected, or will affect, performance.

(vi) Consider the duty to act in good faith, and to mitigate the damage caused to the counterparty.

Also the non-defaulting party should pay attention and not underestimate the weight of the communications exchanged during this emergency phase. In particular:

(i) In case of delay or interruption of the performance, the non-breaching party should always reserve its rights, even in case of renegotiation of the contractual terms. Facts may be

[8] See Article 91 of the Decree.

better evaluated at a later stage, once the emergency has finished, and there may be room to seek damages in case of any abusive conduct.

(ii) Carefully review the dispute resolution clause and the possible applicable steps/terms (multi-tier clauses, possible forfeiture terms) and promptly activate the necessary measures, e.g., starting an amicable negotiation, or sending a warning letter/formal claim. It is advisable to seek guidance from the beginning.

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