

Briefing March 2020

Disruption to Contracts Resulting from COVID-19 and Governmental Measures

The continued spread of COVID-19 and governmental measures to combat the pandemic will inevitably disrupt contracts. They will do so in different ways, and depending on the specific situation, various legal concepts may apply. Typically, parties in essence ask if they are exempt from performing as contracted, if they are exempted from damages, if they still need to perform, if it is still possible to perform but performance has become more onerous or whether the entire purpose of the contract is defeated. Furthermore, parties may look for ways to exit the contract, including a situation where the creditor anticipates the debtor will no longer be able to perform at the relevant point in time.

Overview

In cases where the COVID-19 pandemic or governmental measures disrupt contracts, it is necessary to analyse the situation carefully to determine the appropriate legal instrument to address it.

Depending on the situation and the priorities of each specific party, contractual arrangements such as *force majeure* clauses may provide an adequate answer. But this is not necessarily so. It may well be the case that general or specific termination rights or instruments of general contract law allowing for rescission due to mistake (*Irrtumsanfechtung*), adaptation of the contract due to changed circumstances (*clausula rebus sic stantibus / hardship*), termination for anticipatory breach of contract (*antizipierte Vertragsverletzung*), exit from the contract against payment of a penalty (*Wandelpön*) or that destroy or impair the legal validity of the contract due to impossibility will be able to provide the proper course of action.

Case Profiling

For a proper evaluation of the legal situation, parties should first set up a case profile. Preliminary questions that could provide guidance include:

Which of the parties is affected? Which party owes monetary performance, which party owes non-monetary performance? Is the contract a one-off contract, an instalment contract or a long-term contract with recurring performances? What is the nature and what are the processes behind each individual obligation under the contract? Which contractual obligations are affected? Is performance still possible, even if it has become significantly more onerous? Is counter-performance expected to remain possible? Does the pandemic itself impede performance, or is it a result of a governmental measure taken in response to the pandemic?

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Following on from the case profile, parties should then define their priorities, which will, to a large extent, be driven by commercial / business considerations:

Exiting the contract (potentially irrespective of exit costs)? Release from performance? Exemption from damages? Adaptation of the contract (postponement, price adjustment etc.)? Recovering advance payments?

Legal Concepts Available

Applicable Law

In order to determine the legal concepts best suited to address the identified priorities, it is necessary first of all to determine the applicable law. Switzerland is party to the 1980 United Nations Convention on Contracts for the International Sale of Goods ("CISG").

The CISG applies to sales of existing goods, but also to contracts for the sale of goods to be manufactured, even if such contracts under the Swiss Code of Obligations ("CO") would qualify as work contracts (*Werklieferungsverträge*). It also applies to mixed contracts, unless service obligations under the contract make up for the preponderant part of the obligations of the supplier of the goods.

Courts have consistently held that choosing Swiss law without excluding the CISG or specifying that the CO should apply leads to the application of the CISG. In the present context, the available legal concepts and results differ materially between CISG and CO. A careful analysis of the applicable law is therefore imperative.

Force Majeure Clauses

Irrespective of whether the CISG or the CO applies, regard must first be had to the contents of the particular contract. Significant attention is currently devoted to *force majeure* clauses.

Parties need to check whether the particular clause exempts only from damages (as is frequently the case) or also releases from performance itself (e.g. in corporate transactions in the form of material adverse change clauses).

In either case, it is necessary to examine, whether the pandemic and / or any governmental measures are covered by the wording of the clause or, as the case may be, by any definition in the introductory part of or annex to the particular contract.

Parties then need to clarify, if any termination right triggered by a *force majeure* event is mutually available or available only to the respective counterparty.

In addition, *force majeure* clauses may require that the party relying on *force majeure* notifies the counterparty. In as far as the clause itself, or the contract otherwise, sets forth requirements with respect to time, form and addressee of any such notification, they must be observed.

Further questions arise, if the particular *force majeure* clause requires (as is frequently, but not always the case) that the *force majeure* event must have been unforeseeable, unavoidable and could not have been overcome by the party now seeking relief under the clause.

Impossibility

Under the Swiss CO, impossibility subsequent to the conclusion of the contract releases both sides from their obligation to perform and leads to the unwinding of the contract under the rules of unjustified enrichment (Art. 119 CO, Art. 62 CO). An exception is typically made for long-term contracts, where unwinding of past performances would be unreasonably complicated.

Whether performance is actually impossible is a question of the circumstances of the particular case. If the contract contains a *force majeure* clause providing exemption only from damages, the interplay of such a clause, especially its definition of a *force majeure* event, with the notion of impossibility will have to be clarified.

Where one party has caused subsequent impossibility by negligence, the other party will have a claim for damages (Art. 97(1) CO).

Under the CISG, Art. 79(1) exempts a party from its liability to pay damages if there was an impediment to such party's performance that was beyond its control, unforeseeable, unavoidable and could not have been overcome by the affected party. The general view is that even though Art. 79(5) CISG preserves all remedies except damages, in case of such impediment, the affected party is also released from performance. However, unless declared avoided, the contract will remain in existence, despite the impediment.

Adaptation of the Contract

Under the Swiss CO it is recognized that courts may adapt the contract to changed circumstances if such circumstances did not exist at the time of contracting, were unforeseeable, and significantly alter the balance between performance and counter performance. The standard is very strict.

For work contracts, a specific rule exists in Art. 373(2) CO, allowing the court to increase the remuneration for the contractor, in case completion of the work has become overly onerous due to such changed circumstances. If adaptation of the contract is not reasonably possible, the court may dissolve the contract.

Whether such adaptation is also available, where performance by both parties is still possible, the balance has not changed, but performance of the contract no longer makes any sense and it is clear that the parties would not have entered into the contract under the new circumstances, is unclear. Complex questions will arise with respect to delimiting the respective scopes of impossibility, adaptation of the contract and rescission based on mistake, if the purpose of the contract is defeated.

Contractually agreed adaptation mechanisms (e.g. price escalation / adjustment clauses, hardship clauses) are enforceable. Frequently, such clauses will require the parties to enter into good faith negotiations regarding the fate of the contract.

Under the CISG, there is no explicit provision addressing adaptation of the contract. It can however be argued that adaptation of the contract should also be possible, where the CISG applies.

Rescission for Mistake

The Swiss Supreme Court accepts that a party declares rescission for mistake (*Irrtumsanfechtung*, Art. 23, 24(1) No. 4 CO) on the grounds that such party was in error about future developments or events. Crucially, the party relying on this concept needs to demonstrate that, at the time of contracting, it had a concrete expectation of whether a development or event would or would not materialise. If the rescinding party was in error due to its own negligence, it is liable for damages to the counterparty (Art. 26 CO).

Default Termination Rights

Under the Swiss CO, various termination rights exist that allow an exit from the contract.

For mandate agreements (*Auftrag*) there is a mandatory termination right that can be exercised at any time (Art. 404(1) CO). If exercised at an onerous point in time for the other party, the exiting party is liable for damages (Art. 404(2) CO).

With respect to work contracts (*Werkvertrag*), the ordering party may at any time exit the contract (Art. 377 CO), but must hold the other party harmless.

For certain long-term contracts (rent (Art. 266g CO), agency (Art. 418r CO)) the Swiss CO sets forth the right to terminate for cause. For other long-term contracts, such right is recognised by the Swiss Supreme Court, even though not expressly set forth in the CO. The exiting party must demonstrate that it cannot be reasonably expected to continue the contract. Courts enjoy broad discretion in this area.

Where the contract contains a contractual penalty (*Konventionalstrafe*), it is for the debtor to prove that in exchange for paying the penalty, it is allowed to exit the contract (Art. 160(3) CO).

Finally, under the Swiss CO, the concept of termination for anticipatory breach of contract is accepted and applied by courts in practice. Where it is clear that the debtor will not (be able to) perform at the relevant point in time, the creditor may declare termination of the contract (analogous application of Art. 97 CO, Art. 108, 107(2) CO). In the current

situation, this will be of particular interest in circumstances where the creditor owes monetary performance, potentially even advance payments, but it is clear that the debtor will not be able to render the non-monetary performance.

Under the CISG, avoidance rights exist in case of fundamental breach (Art. 49(1)(a), Art. 64(1)(a) CISG), or, in case of full absence of performance, once an additional period of time set by the creditor has lapsed (Art. 49(1)(b), Art. 64(1)(b) CISG). The CISG also recognises the concept of avoidance for anticipatory breach of contract (Art. 72, Art. 73(2) CISG).

Summary and Outlook

Where the COVID-19 pandemic or the respective governmental measures disrupt contracts, various legal instruments are available to the parties. Careful case profiling and defining of priorities will determine which instrument best addresses the specific situation of each party.

Termination rights may be the fastest way to exit a contract, but may or will come at a price. *Force majeure* clauses may help with regard to damages, but not with the desired release from performance. Adaptation of the contract may be the most flexible of the instruments, but its traditional definition and scope are rather narrow. Rescission based on mistake may help with exiting the contract, but will typically also lead to a full unwinding of prior performances rendered.

Furthermore, it is not always easy to clearly delimit the respective scopes of application of the individual legal instruments and courts will play an important role in achieving more legal certainty in this respect.

Key Contact



Dr. Andreas Länzlinger

Partner

M: +41 58 262 53 50

andreas.laenzlinger@baerkarrer.ch



Dr. Pascal Hachem

Associate

M: +41 58 262 54 91

pascal.hachem@baerkarrer.ch

Further Contributors

Michael Trippel

Partner

T: +41 58 261 50 00

michael.trippel@baerkarrer.ch

Dr. Urs Kägi

Partner

T: +41 58 261 56 13

urs.kaegi@baerkarrer.ch

Bär & Karrer Ltd.

Brandschenkestrasse 90

CH-8002 Zürich

Telefon: +41 58 261 50 00 Fax:

+41 58 261 50 0

zurich@baerkarrer.ch

Quai de la Poste 12

CH-1211 Genf

Telefon: +41 58 261 57 00

Fax: +41 58 261 57 01

geneva@baerkarrer.ch

baerkarrer.ch

Zürich, Genf, Lugano, Zug

