COVID-19: “I STARTED SOMETHING I COULDN’T FINISH” - LEGAL CONSEQUENCES OF THE PANDEMIC ON CONTRACTS GOVERNED BY ITALIAN LAW

Date: 19 March 2020

Italian Corporate M&A Alert

By: Giampaolo Salsi, Bruno Vascellari, Carolina Sanna

"I started something I couldn't finish", goes the song by one of the eighties' most influential bands [1]. And, indeed, in these trying times, under the threat of the COVID-19 pandemic and the increasingly strict measures that are being taken by governments to contain the spreading, several businesses are experiencing an inability, be it legal, factual or financial, to complete, timely or altogether, performance of their contracts.

Against this backdrop, once all amicable venues have been exhausted (or, simply, as a leverage to facilitate their success), it becomes crucial to understand what legal remedies, if any, are available, to businesses to justify delays, seek adjustments of economic terms, or invoke plain termination of their contractual obligations.

The following, is a summary, not purporting to be comprehensive, of the statutory remedies available under Italian law to deal with instances bearing resemblance with the international notions of "force majeure", "hardship", "change in circumstances" or "frustration", in a scenario characterized by what the World Health Organization has already qualified as a pandemic [2].

1. IMPOSSIBILITY OF PERFORMANCE

Pursuant to Art. 1256 of the Italian Civil Code, "... an obligation is terminated when, for reasons beyond the debtor's control, performance becomes impossible". And "if impossibility is only temporary, the debtor, for as long as it is continuing, is not liable for late performance. However, the obligation is terminated if impossibility, having regard to the obligation's title or the nature of its object, lasts until the debtor can no longer be deemed to be bound to perform, or the creditor is no longer interested in obtaining performance." [3]

In the event a contractual obligation has been terminated for impossibility, the party which was entitled to receive performance under that obligation, will have the right to seek relief under Art. 1463 of the Italian Civil Code, in that "the party released from due performance on grounds of supervened impossibility, cannot claim performance of the other party, and must return what it has already received ...". If impossibility of one obligation is only partial, the other party will be entitled to a reduction of its obligation, or can withdraw from the contract, if he has no "appreciable interest" in partial performance.

Among the reasons that the judiciary in this country has deemed to constitute instances of impossibility, there are orders and prohibitions issued by Public Authorities (legislative, administrative and judicial), that specifically prevent one party from lawfully performing his obligations, i.e. the so-called "factum principis". The containment measures recently issued by the Italian Government - and, in particular, the Prime Minister's decrees (d.P.C.M.) of 8, 9 and 11 March 2020 - where they provide for mandatory closure of certain business activities, appear to meet the 'impossibility test' for obligations owed by businesses so affected, in that the "*factum principis*" constitutes an insurmountable impediment beyond the obligor's control, at least insofar as the impeding circumstance was not foreseeable, as at the time in which the obligation was undertaken [4].

Given the temporary nature of the emergency measures adopted by the Government (the subject decrees are meant to be applicable until the beginning of April, although their terms may be extended, depending on the epidemic's evolution), a majority of the affected contractual relationships will likely fall within the scope of application of the second paragraph of Art. 1256 (temporary impossibility), therefore affording only temporary relief from non-performance, unless, of course, the nature or subject matter of the obligation (e.g. perishable goods), or the fading of the creditor's interest to performance (e.g. supplies with a prevalent seasonal element) command otherwise.

But what if the obligor does not belong to any of the business categories affected by closure orders, and yet the health and sanitary emergency constitutes an insormountable impediment, beyond his control? Let's assume that a tour operator is no longer in a position to ensure transportation of its clients to destination, due to suspension or cancellation of airline routes triggered by the sanitary emergency; or that a supplier of goods cannot meet its delivery obligations, for unavailability of carriers to the port of destination, which, again, is prompted by local sanitary conditions. In principle, the same remedies available in case of "*factum principis*" should be accessible, on condition that the 'impossibility test' (absolute impediment, beyond the obligor's control and unforeseeable, applying normal diligence, as at the time in which the obligation was assumed) is met.

Even more to the point, a recent orientation of the Italian Supreme Court [5] has taken the view that a party entitled to receive performance of an obligation - performance of which is still entirely possible -may refuse it (and claim restitution of any consideration already paid), if, due to a change in circumstances, the contract's actual function ("*causa in concreto*") results frustrated. In other words, although performance of a contract's typical obligation remains technically possible, if supervening and unforeseeable circumstances (beyond the party's control) occur that make it impossible for one party to receive performance (e.g., in the case examined by the Court, the serious illness of a buyer of a holiday package, which prompted the judges to consider the relevant contract terminated and the customer entitled to restitution of the paid price), that party will be entitled to refuse performance and consider the contract avoided, for subsequent lack of its "*causa in concreto*". The relevance of this doctrine in the current scenario is apparent, at least in those circumstances in which - even in the absence of a "*factum principis*" preventing performance - the effects of the pandemic frustrate irreparably the very reason of the transaction.

2. HARDSHIP

A separate remedy provided under Italian law - even if the contractual obligations are still possible, nor has the

contract lost its "*causa in concreto*" - entitles a debtor to trigger a revision of terms, or, absent that, terminate the contract, in cases where due to "extraordinary and unforeseeable" new occurrences, performance of his obligations has become "excessively burdensome" (Art. 1467 of the Italian Civil Code).

The judiciary has construed the notion of "extraordinary and unforeseeable" new occurrence, to specify that while the "extraordinary" character needs to be of an objective nature, having to take into account measurable elements such as frequency, magnitude, intensity, etc., which therefore can be appreciated also from a statistical perspective, the "unforeseeability" needs to be considered from a more subjective standpoint, as it pertains to the parties' typical prognostic ability, having regard to their professional status and industry [6].

It is further specified that the remedy in question does not apply if the aggravation occasioned by the new occurrence remains within "the contract's normal risk" (Art. 1467 of the Italian Civil Code, second paragraph). As a consequence, those contracts which by their nature (e.g. insurance, gaming, betting), or by the parties' express or implicit agreement are inherently resistant to change in circumstances, cannot be terminated on grounds of hardship. It is worth mentioning that some precedents have also taken the view that the remedies under Art. 1467 would not be available for those contracts that, for their particular legal regime or because of specific stipulations adopted by the parties, already contemplate *ad hoc* mechanisms for their rebalancing, in case of new occurrences affecting the original bargain. In the negotiating and drafting practice of share purchase agreements, for instance, the express qualification of the agreement as "*aleatorio*" (i.e. having an inherent 'risky' nature) is becoming increasingly common, thereby excluding at the outset relief under Art. 1467 [7].

Due to the remedy's exceptional nature and its limited application by courts (usually, in instances characterized by lasting, structural and severe adverse effects on a macroeconomic level), it is perhaps still too early in the pandemic's evolution to predict the magnitude of the prejudice that it will bring to the country's economic fabric or some of its sectors and industries. Yet, in perspective, particularly so if the emergency or its effects on the economy lasted for several months, increasing recourse to Art. 1467 of the Italian Civil Code can be envisaged.

3. THE "QUASI-MORATORIUM" ON OBLIGATIONS UNDER THE "*CURA ITALIA*" DECREE

Finally, it is worth mentioning an extraordinary legislative measure, adopted by the Government within the package of urgent provisions aimed at supporting families, workers and businesses, in the wake of the COVID-19 emergency.

Art. 91 of Law Decree no. 18 of 17 March 2020 (the so-called "*Cura Italia*" decree) has introduced a "quasi-moratorium" for all obligations, performance of which is prevented or hindered as a consequence of the containment measures enacted to limit the spreading of the contagion.

Namely, the freshly enacted provision stipulates that "compliance with the containment measures ... will always be considered for purposes of excluding, pursuant to and under Arts. 1218 and 1223 of the Italian Civil Code, the debtor's liability, also in connection with the application of any forfeitures or liquidated damages stemming from late or omitted performance".

Arts. 1218 and 1223 of the Italian Civil Code regulate respectively the conditions under which a non-performing obligor is liable for damages (failure to prove that performance was impossible, for reasons beyond the obligor's control), and the constituting elements of indemnifiable losses (costs and loss of profit, to the extent they are immediate and direct consequence of non-performance).

The above principles - the ordinary application of which imposes a particularly stringent test on obligors who seek to be exempted from liability - appear considerably mitigated as a result of the new emergency provisions. In particular, it is reasonable to opine that judges will be required to use a more liberal attitude in assessing the conduct and extension of liability of non-performing obligors, in all instances in which omitted (or late) performance was occasioned or affected by the need to comply with the extraordinary measures of containment enacted by the Government. This appears to go way beyond the scope of impossibility for "*factum principis*" (see paragraph 1, above), as the intensity of the containment measures ranges from closures of certain business activities (which, as outlined above, under certain conditions may qualify as ground of impossibility, under Art. 1256), to mere restrictions on people's ability to move, and yet all of these measures appear potentially relevant - insofar as an aggravation of the obligor's position originated thereby can be established - for purposes of mitigating the obligor's liability.

Even more explicitly, the new provision expressly refers to "… application of any forfeitures or liquidated damages connected to late or omitted performance" among the matters that would need to be submitted to the judge's appreciation in the light of these new exceptional parameters of liability, which leads us to believe that even enforceability of those typical expressions of the parties' autonomy in determining the sanctions (and the allocation of risk) applicable to their deals, would be suspended.

Due to the novelty of the subject provision, it is not possible to safely assess to what extent it will be applied in practice by courts, or how liberal and potentially extensive the interpretation and construction of the expression "compliance with containment measures" will be. Yet, this is undoubtedly an example of legislative policy, which, under the spur of an extraordinary situation of emergency, expresses a clear favor to obligors in state of hardship.

* * *

While the scenario is still kind of magmatic and everchanging, we wanted, without purporting to be comprehensive, to give a general outline of the principal statutory remedies availble in this country to deal with the impact on transactions and, consequently, cash flows and business strategies of this unexpected emergency.

Needless to say, for those who are currently negotiating the terms of their business transactions, exclusive reliance on statutory remedies is not recommendable. Prudence will be key, commanding for an even more scrupulous risk assessment approach in negotiating and drafting new contracts, with a view to try and address with appropriate stipulations, clauses and security the contingencies that may stem from the current and ongoing adversity.

NOTES

[1] The Smiths, "I Started Something I Couldn't Finish", in "Strangeways, Here We Come", Manchester, 1987.

[2] WHO Director-General's opening remarks at the media briefing on COVID-19 - 11 March 2020 (www.who.int).
[3] Similar principles apply to commercial transactions governed by the United Nations Convention on Contracts for the International Sales of Goods (the so called "Vienna Convention" of 11 April 1980), Art. 79 of which stipulates that "A party is not liable for a failure to perform any of his obligations if he proved 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."
[4] But see the comments on the recently enacted "quasi-moratorium" on obligations, under paragraph 3 below.
[5] Amongst others: Cass. no. 18047/2018.
[6] Cass. nos. 2661/2001, 22396/2006.
[7] Possible changes in circumstances, especially so when occurring in the interim period between signing and closing, will need to be carefully addressed with specific 'MAC' (acronym for Material Adverse Change) clauses.

KEY CONTACTS

GIAMPAOLO SALSI
PARTNER

MILAN
+39.02.3030.291
GIAMPAOLO.SALSI@KLGATES.COM

BRUNO VASCELLARI
COUNSEL

MILAN
+39.02.3030.2925
BRUNO.VASCELLARI@KLGATES.COM

