

HOW COVID-19 AFFECTS CONTRACTUAL OBLIGATIONS

1. INTRODUCTION

A state of alert has been declared. This is an exceptional regime, established in the Spanish statal legislation, which allows the Government to take severe measures in situations of "*serious disturbances to normality*", ranging from disasters or public misfortunes to "*health crises, such as epidemics or serious pollution situations*", such as the one we are dealing with (and worrying about).

The measures of Royal Decree-Law 8/2020 states the closure and cessation of commercial activity, hotels, restaurants and some other sectors. The opening of retail premises and establishments to the public is also suspended, with some exceptions.

According to the survey carried out¹ a few days ago by the Consumer and User Organization (OCU in Spanish) in relation to the coronavirus epidemic or Covid-19: 48% of those surveyed fear contagion, but the majority (73%) confess to being mainly concerned about the damage this situation will cause to the economy and its consequences.

The concern is unavoidable: “if my company closes down, will I be out of work?”, “What if I do not lose my job but my salary is reduced?”, “What if my expenses continue, but the income suddenly ceases to exist?” or “What if I made a commitment but now I may not be able to fulfill it?”

And what if I have to fulfill it, even if I can't? How does *force majeure* operate? How do I deal with the contracts I signed in the short term that may still be affected by Covid-19?

It is undeniable that the cessation of activity and the nationwide consumption and provision of services restriction directly affect the obligations and commitments established in the contracts, greatly compromising its compliance.

¹ A representative sample of the Spanish population has been used: adults between 18 and 74 years old

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In light of the above, it is essential to know that there is a possibility of modification, suspension, termination and/or extinction of contracts regarding civil and commercial matters, as described below.

2. APPROACH TO LEGAL SOLUTIONS

Spanish law provides: *(i)* on the one hand, mechanisms for modifying the obligations established in the contracts and; *(ii)* on the other hand, mechanisms for the suspension, resolution or early termination of the contracts.

At the same time, it should not be forgotten that the parties may mutually agree to renegotiate or modify their contracts as appropriate.

2.1. THE FORCE MAJEURE

Article 1.105 of the Spanish Civil Code states that *"Apart from the cases expressly mentioned in the law, and those in which the obligation is so stated, no one shall be liable for events that could not have been foreseen, or which, if foreseen, were unavoidable"*.

This is what is meant by *force majeure*. The Spanish Civil Code does not do so, but jurisprudence has over the years coined a definition that would link *force majeure* with *"Any unforeseeable event, or one that, when foreseen, is inevitable, and foreign to the persons and the activity of exploitation of the person responsible, produced from outside by natural forces or by acts of third parties"*.

2.1.1. ARE WE IN A FORCE MAJEURE SITUATION?

The question that immediately arises for all of us is: is the current health crisis situation of Covid-19 a cause of *force majeure*?

The instinctive answer to this question would be “yes”, and some of the measures that have been established in compliance with the Royal Decree-Law and the state of alarm in some areas such as labour would contribute to this positive answer.

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But we should not let ourselves be carried away by automatism. The jurisprudential doctrine teaches us that in order to weigh up their concurrence, each specific case must be assessed, and this has been the case until now, and we foresee that it will be the case when the time comes to assess the contractual consequences of this situation.

It is no secret that the state of alert approved by the Government is preceded by a pandemic which is undoubtedly an unforeseeable event that officially restricts and limits the freedom to provide services, affecting the normal fulfilment of obligations between the parties.

Consequently, this epidemic could be considered as a case of *force majeure* in which the parties could be exonerated from liability for failure to comply with their obligations, provided that it can be proved (i) that this crisis arose after the contract was concluded, (ii) that any diligent effort in the performance of the contract is totally useless in order to comply with it, and (iii) that its effects are completely alien to the person alleging it, i.e. that the alienity cannot be confused with those circumstances that have to be assumed and foreseen by the contracting party on whom the performance depends.

Thus, in order for *force majeure* to be admissible, a total absence of fault must be proved, since fault or lack of due diligence is incompatible with *force majeure*.

Consequently, as stated above, there is no automatic reflection that leads us to think that anyone and in any case can take refuge in *force majeure*, since the success of the invocation of no matter which of the causes of exoneration in cases of contractual non-compliance will depend in any case on the nature of the contract, the effect of the state of alarm and the impact of the coronavirus itself on its execution.

Thus, also the measures adopted to do so, while taking into account the economic sector and the regulations applicable in the specific case. This is the first thing to do in any case is to examine the contract carefully to ensure that either *force majeure* is excluded (i.e. even in the case of unforeseeable events, *force majeure* cannot be invoked) or that its effects and consequences are already regulated (in which case the regulation of the relationship between the parties must be taken into account).

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2.1.2. CONSEQUENCES OF *FORCE MAJEURE*

Firstly, and repeating our initial reflection, the fact that we are dealing with a case of *force majeure* does not imply that, mechanically, the parties can deviate from the contract. The fulfilment of the contractual obligations (*pacta sunt servanda*) remains in force.

A different matter is whether these obligations, as a result of a situation of *force majeure*, are already impossible to perform (due to material impossibility and/or because their performance has become futile at another time), in which case it will be necessary to resort to the mechanisms of contractual resolution provided by the Spanish Civil Code.

Or, if it is not impossible to provide the service, the execution and fulfilment of the contract must be suspended or postponed. Either resolution or suspension, what will be the consequences?

Even in its brief definition of *force majeure* the Spanish Civil Code gives us the clue that "*no one will be liable*" (art. 1.105 CC) for those unforeseeable events, which jurisprudence has translated into the fact that the contractor who cannot comply with his obligations will not be obliged to pay damages to the other party (all of this, as it is worthwhile to insist, regardless of the contractual regulation that each case may have).

In other words, we will move away from the general system ex art. 1.124 CC, according to which in the event of non-compliance it will be possible to opt for resolution or compliance, always with payment of damages.

But what will happen in those cases where the resolution (but only the suspension and consequent postponement of the contractual obligations) is not appropriate, will the contractor (whose obligations were suspended as a result of *force majeure*) come to comply at a later date on exactly the same terms initially foreseen?

Once again, the answer lies in examining the contract and then in analysing the specific conditions under which the suspended obligation is to be honoured, since it is quite possible that in such cases it will be difficult or impossible for the performance to be carried out on the same terms as those originally envisaged in the contract.

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This would open the door to the application of the *rebus sic stantibus* clause (to which we shall refer below) in order to re-establish the balance between the performances.

There will be many occasions when, once the existence of *force majeure* has been accepted by the parties, the contracting party who is the creditor of the performance intends that, once the *force majeure* phase has been overcome, performance of the obligation will be made in a shorter time than that contractually established, thanks to acceleration plans, early delivery, etc.; this situation will in most cases represent extra costs, rescheduling... for the contracting party who is the debtor.

If this were to happen we could speak either of a contractual novation or of the application of the *rebus sic stantibus* clause.

2.1.3. HOW TO TRADE IN THE CONTRACTS THAT ARE CURRENTLY BEING NEGOTIATED?

One of the concerns that some of our clients are expressing is what happens with the contracts that are being negotiated/signed at this time, already with the Covid-19 installed in our lives.

The first idea that comes to mind, and it is correct in view of the very concept of *force majeure*, is that it would no longer be possible to claim *force majeure*, since the characteristics of unpredictability and inevitability would have been lost. And that will have to be the general rule.

However, we are still at a time when no one, not even the health authorities, are able to predict what the development and evolution of the pandemic will be, and it is by no means ruled out that within this generalized context of *force majeure*, there may arise, say, "sub-events" of *force majeure*, such as new decisions by our local or supranational authorities that place additional restrictions on our ability to act that impact the development of business.

In such cases, it will be essential that in our offers and, of course, in the contracts, the treatment the parties wish to give to possible new events or derivations of *force majeure* is absolutely clear so that, either the creditor contracting party can demand performance

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in view of the fact that the other contracting party already knew the situation in which the contract was signed and even committed itself; or the debtor contracting party may raise new circumstances of *force majeure* beyond those already known, *i.e.* in these circumstances a foresight effort is required to regulate the different scenarios that may occur depending on the information that is currently known.

2.2. REBUS SIC STANTIBUS CLAUSE

As we mentioned above, there is a legal mechanism, called *rebus sic stantibus* (Latin expression that can be translated as "*while things are like this*") that implies a modification of the obligations initially assumed by the parties, and which refers to a principle of law -built up by case law- by virtue of which it is understood that the stipulations laid down in contracts have irremediably taken into account the circumstances prevailing at the time of their conclusion, so that a substantial and unforeseeable alteration of those stipulations may give rise to the possibility of modifying those stipulations, with the sole aim of rebalancing the mutual benefits of the parties.

It is therefore a clause that would allow the restoration of the balance of benefits between the parties to a contractual relationship and applies when, due to circumstances that are supervening and totally unforeseen by the parties, one of them is deprived of the right to claim.

It seems reasonable to consider, as we have already said, that this pandemic can be described as that unforeseeable event which, if we had known about it beforehand, we would not have been bound by certain legal relationships.

And it seems clearly unjust to demand that in "*times of crisis*" we respond in identical circumstances to those obligations assumed in "*times of peace*".

In previous situations similar to the current one (*i.e.*: the financial crisis of 2008) the jurisprudence admitted the application of the above mentioned *rebus sic stantibus* clause due to the situation of extraordinary alteration produced by the serious economic and social situation.

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Given the seriousness of the current situation, it is perfectly reasonable to think that the state of alarm should be considered, by analogy, as an extraordinary circumstance and, consequently, the application of this clause should be allowed.

However, it is generally accepted that the aforementioned mechanism of the *rebus sic stantibus* clause does not have rescissive, resolutive or extinctive effects.

It will therefore only have the effect of modifying the contracts with the aim of compensating for the imbalance in the benefits between the contracting parties. Only in extreme cases, situations can be reached in which a judge can accept the contractual termination because of such a substantial change.

In any case, it should be remembered that according to our case law this clause must always be applied in a restrictive, exceptional and cautious manner, since it constitutes, in a certain way, a legal anomaly, as it is contrary to the fundamental principle of our law of contracts and obligations which is that of contract compliance (*pacta sunt servanda*).

Traditional case law has required the following conditions for its invocation:

- i.** That an extraordinary alteration of the circumstances has taken place at the moment of the fulfilment of the contract in relation to the concurrent ones at the time of its celebration;
- ii.** That, as a result of that alteration, there is an exorbitant disproportion, beyond all calculation, between the performance of the contracting parties that actually brings the contract down by annihilating the balance of the performance
- iii.** That all this happens because of the occurrence of radically unpredictable circumstances
- iv.** That there is no other means of redressing the asset imbalance caused, given that this is an exceptional clause, which must be applied with caution.

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Traditionally, moreover, this clause was applied only to successive contracts. However, precisely as a result of the judgments following the economic crisis of 2008, the position of the courts has become more flexible and it is also applied to contracts that are not strictly successive but which, by their nature, are prolonged in time, with contractual phases or milestones that extend their execution.

3. CONCLUSION

It is recommendable to stay calm but to act quickly. Before assessing any alternative involving the termination of contractual relations or litigation, it is advisable:

- ❖ To study the contract(s) to verify the existence of assumptions and alternatives already contemplated in its clauses.
- ❖ To negotiate with the other party to propose amicable solutions regarding the possible suspension or modification of the conditions of the contract.
- ❖ To take advice on the possible effects and implications of a possible termination or cancellation of the contract, as well as the application of the *rebus sic stantibus* clause
- ❖ To proceed with the most suitable alternative for the specific case.
- ❖ To be especially careful with the contracts that are already being negotiated/concluded with Covid-19 between us, in order to foresee the possible consequences of this crisis on their execution.

Finally, it is important to note, for everyone's peace of mind, that Royal Decree-Law 8/2020 provides for the suspension of the terms and interruption of the time limits laid down in the procedural laws for all jurisdictional orders.

This calculation of the time limits will be resumed at the moment that the Royal Decree-Law or, if applicable, its extensions, becomes ineffective.

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This resumption does not mean that the period starts from zero, but from the moment when the period was "*frozen*", so that, by way of example, if the period was interrupted on the 5th of the 20th, 15 days will remain at the time of resumption.

It also provides for the suspension of the limitation and lapse periods of any actions and rights during the period of validity of the state of alert. Therefore, any time limit for bringing actions arising from a breach of contract will be suspended or interrupted.

As we said before, the time to act is now, but with peace of mind and in the hands of trusted lawyers. Giménez Torres Abogados is at your entire disposal to rebalance these extraordinary moments.

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