

Legal consequences of interruptions in the supply chain and of changed market conditions on supply and service contracts as well as M&A transactions due to the spread of the Coronavirus- a practical guide

In the current context of disruptions in production and supply due to the spread of the Coronavirus, the question arises as to the rights and obligations of the contracting parties under the changed conditions for the various constellations of doing business. These include contracts for the supply of goods and the provision of services (below items 1. and 2.). The second emphasis of this briefing document will be on the effects of the crisis on M&A and other corporate transactions (below item 3.). Our intention is to provide an overview of the Parties' rights and obligations in the typical scenarios arising in this new crisis. Only being fully informed about the legal position allows to develop successful ways to proceed. The most heavily affected sectors are logistics, travel and leisure as well as trade fairs and exhibitions.

1. Force majeure, hardship and disruptions to the basis of business in supply and service contracts

a) Force Majeure - Legal impossibility to render performance

For the Supplier, it is obvious to invoke Force Majeure due to the lack of parts or personnel (infection, quarantine or travel restrictions). In the case of Force Majeure, the Supplier is at least temporarily unable to perform. A distinction must be made between Force Majeure, Hardship and the ceasing to exist or change in the basis of the business. Force Majeure is understood to be an unforeseeable (as opposed to merely unforeseen) and unavoidable event occurring after the conclusion of the contract, which is beyond the control of the parties to the contract and cannot be eliminated by reasonable and acceptable means. This may well apply to the effects of the Coronavirus. In such a case, the Supplier's obligation to perform shall be suspended for the duration of the event without the Supplier having to pay damages.

Whether the prerequisites of Force Majeure are fulfilled, must be assessed on a case-by-case basis. Among other aspects, it depends on whether alternative procurement channels are available at acceptable conditions (in which case performance is not legally impossible, but there may be hardship, see below) and whether the supplier has accepted legal responsibility for the procurement risk. This is the case if the product to be delivered by the Supplier is not a specific one but defined by its class or category (*Gattungsschuld*).

In travel law, epidemics are generally recognised as force majeure. In this respect, it is significant that the World Health Organisation (WHO) declared an international health emergency on 30 January 2020 because of the Coronavirus.

b) Hardship – Economic impossibility to render performance

A distinction must be made between force majeure and those cases in which the performance means hardship for the Supplier. In connection with the Coronavirus, the issue here is whether unforeseeable increases in the cost of purchasing materials make performance economically impossible. Hardship also releases the Supplier like force majeure from his obligation to perform if, taking into account the content of the contract (e.g. the urgency of the delivery - just in time) and in compliance with the principles of good faith, the burdens resulting from the fulfilment of the Supplier's obligation to perform are grossly disproportionate to the recipient's interest in the delivery. In the case of the obligation to deliver just in time, the interest of the customer is to be classified as relatively high. An example of hardship under the current circumstances is the availability of components previously sourced from China through replacement suppliers in Germany, which can only be purchased at disproportionately high prices.



Neither legal concept is specifically regulated in German law. It is therefore advisable to define in the contracts the conditions and legal consequences of such events in an appropriate manner for the individual case. Frequently, these aspects are addressed in general terms and conditions. In this regard the question then arises whether they can withstand the review of content, which is more generous in business relations than in relation to consumers.

Experienced advisors should be consulted to assess the rights of the parties under the current acute circumstances. Such experts can also assist in providing guidance under which conditions the Supplier is obliged to inform the customer in advance of delivery bottlenecks or failures in order to avoid claims seeking compensation of damages arising from a breach of ancillary obligations related to the contract.

The principles set out above apply equally to supply contracts for goods and service contracts. In the case of service contracts, the availability of professionally trained personnel can be problematic for the reasons mentioned above (risk of infection, quarantine, travel ban).

The Customer will usually reject the Supplier's invoking force majeure or hardship and will in turn assert claims for delay in delivery. The Customer takes an interest in being entitled to compensation of damages caused by the delay. Delay in performance requires that for the Supplier it is still possible to render his performance. In this respect, special regulations apply in commercial transactions in the case of purchases in which the customer has a right to reject performance if the Supplier does not deliver in time. According to this concept, the Customer may withdraw from the contract if delivery is not made at the agreed time or not within the specified period. In these cases, there is therefore a right of withdrawal without having to check whether force majeure or hardship is involved. According to the contractual agreement of the parties, the transaction must "stand and fall" with the observance of the precisely defined performance time. In this context it is not relevant for the exercise of the Customer's rights whether the supplier acted with fault.

However, in principle the fulfilment of the Supplier's obligations after expiry of the defined time/deadline remains possible. It is the Buyer who must act and declare the withdrawal to the Seller. This is of great relevance for safeguarding the rights of the Customer in connection with the failure or sustained delay of deliveries and services.

c) Ceasing of existence or change of the basis of the transaction

In this context, the statutory provisions concerning the change or discontinuation of the basis of the transaction (*Geschäftsgrundlage*) are also of importance, i.e. if after the conclusion of the contract the circumstances have changed in a way not provided for in the contract and if, taking these circumstances into account, the contract would not have been concluded at all or would have been concluded on different terms. In connection with the Coronavirus, this concept applies in situations which do not qualify as Force Majeure or Hardship, but in which the balance of the relationship between performance and consideration is severely disturbed – considering the specific circumstances of the individual contract. This includes situations in which the employees designated by the Supplier should refrain from entering an infected area or are subject to other controls that make it impossible for them to participate e.g. in the installation of a machine or training courses. These are cases which do not constitute Hardship (economic impossibility) but which disturb the equivalence of performance and consideration resulting from the contract in such a way that the obligated contractual partner cannot reasonably be expected to adhere to the contractually agreed performance.

The legal consequence of this is first an adjustment of the terms of the contract, such as payment of the additional costs for work carried out by third parties, but possibly also a right of rescission by the Supplier (for example, because of the character of a transaction where the time of delivery is crucial - *Fixgeschäft*). Depending on the case constellation, the Buyer or the Supplier may be entitled to invoke temporary or continuous disruptions of the business basis. Whether the exercise of a right of withdrawal is appropriate for the Buyer depends on whether he can find a replacement at short notice. Under certain circumstances, it may be in the interests of the Customer not to exercise his right of withdrawal and to find an amicable solution with the Supplier.



2. The importance of insurance

In the event of production interruptions or temporary plant closures, it should be checked whether claims exist under the insurance policies taken out by the contract partner suffering the damage. Policies covering losses from business interruption and all-risk insurance may be relevant in this context. Depending on the form of the policy, compensation for retroactive losses may also be claimed. These are business interruption losses as a result of a loss event (in this case loss of production related to the Coronavirus) suffered by the supplier or customer.

In the case of export transactions, it should be investigated which losses are covered by export credit insurance. In the case of new business, consideration should always be given to taking out this cover. In Germany the Hermes Cover sponsored by the Federal Government and coverage by private insurance companies is available. There exist essentially two forms of protection under Hermes Cover: pre-shipment risk cover and supplier credit cover. The former already covers the production process and provides compensation for the manufacturing costs in the event of production stoppage or postponement of the performance period. Here too, it is important that Euler Hermes AG, acting as the Federal Government's representative, is informed immediately of any necessary delays in delivery and performance. Such delays require the consent of the representative of the Federal Government. Supplier credit cover secures the loss of receivables from an export transaction.

3. Effects of changed market conditions on M&A transactions

Current developments are also important in the context of the acquisition of companies and shareholdings. In this respect, the unpredictably strong changes in economic conditions caused by the coronavirus must be considered. These have an impact on the company valuation relevant for the purposes of determining the purchase price if the slump in economic activity as a result of the coronavirus is not regarded as merely temporary. If the weakness of the economies is only temporary, the Sellers' side would argue that the actual picture was distorted. After a short time, everything would be back to the way it was before. From the Buyer's perspective, it will be argued that the production shortfalls will probably not be made up, but also that demand will not simply shift, for example, from the first to the second quarter of 2020. For the overall picture, it is important to assess whether the risk of infection will decrease sustainably when warmer spring temperatures will arrive in the Northern hemisphere, because the virus will then decay faster and the defence systems of those affected will react more effectively. The current speed of the virus spreading in the countries of the Southern hemisphere (where it is currently summer) is an important indicator as to what extent this is true.

a) Transactions at the stage between signing and closing

Force Majeure and other rights due to changed circumstances resulting from the outbreak of the Coronavirus only have legal effect on transactions already signed if the share or asset purchase agreement was concluded before the effects of the virus became manifest. If the transaction had already been completed at that time, barring fraud it is no longer possible to refer to the changed circumstances. If the signing of the company purchase agreement is still pending, the current developments can still be considered in the negotiations.

The date from which the effects of the Coronavirus crisis can be considered as known is likely to be in the second half of January 2020 for transactions whose valuation depends on the situation in China. If the transaction affects the German market without regard to the loss of production in China that had already occurred, then the relevant date should be around 22 February 2020. If the conditions in Italy are relevant, the cut-off date should be considered a few days earlier. Furthermore, the transaction may only be completed after the relevant cut-off date, so that the negative impact of the Coronavirus crisis still falls in the period between the conclusion of the contract and its completion.

One reason for such a period between the conclusion of the contract and its execution may be a condition precedent such as the approval of the competition authority. In such cases, it is in the interest of the Buyer that the Seller's guarantee commitments continue to apply at the time the transaction is executed (so-called bring-down certificate). In principle the Seller's guarantee statements are absolute, but usually the acquisition agreement contains provisions addressing the



relevance of the Buyer's knowledge (so called anti-sandbagging clauses). What are the effects of unforeseeable events? Is the Buyer, if applicable, entitled to refuse the execution of the transaction due to Force Majeure or a substantial change in the basis of the transaction or to agree to the execution only in the event of an adjustment of the purchase price? Or should he choose to close the transaction and enforce warranty or price adjustment claims subsequently?

SPAs often contain so-called MAC clauses, which regulate the conditions under which a material adverse change (MAC) occurs in the period between signing and completion of the transaction and which legal consequences are attached to it. A distinction is made between MAC clauses that only refer to changes in the company (Business MAC) and those that also take into account sectoral or macroeconomic developments (Market MAC) or extend to the financing of the transaction (Finance MAC). The broader the definition of a MAC event, the riskier it is for the Seller, as the transaction may be jeopardized.

In close coordination with the external consultants, it should be determined whether a so-called MAC event was present due to the unforeseeable events resulting from the outbreak of the Coronavirus. In the absence of a MAC clause in the Company Purchase Agreement, the general principles of force majeure, hardship and disruption of the basis of the transaction as set out above shall be applied together with the experts to examine the Buyer's claims due to the changed circumstances with regard to the transaction.

b) Current transactions negotiated and already completed and future deals

In addition, company purchase agreements should be reviewed to determine whether any relevant guarantees or other obligations of the parties have been breached in relation to the outbreak of the corona virus. In the case of contracts currently under negotiation, it is advisable to include in the contract guarantees and commitments on measures relating to the specific risks of the Coronavirus outbreak, such as the continuity of the supply chain, the health of workers and compliance with official requirements (in particular those of the Public Health Office). Such guarantees, however, always relate only to a specific reference date and therefore do not provide any protection with regard to what will happen in the future.

Claims may arise from transactions that have already been completed if the company purchase agreement contains clauses on which one party can base claims based on the outbreak of the Coronavirus. The clause was drafted in case of doubt, without regulating the effects of the virus. However, such claims can still arise from guarantee commitments that can be transferred to the current circumstances. One example is the guarantee, which is quite common in company purchase agreements, according to which the Seller sees no reason why the business of the target company could develop negatively on the date of the guarantee, but if the Coronavirus was actually spreading, the damage was already 'created', so to speak. Because of the high relevance of the questions that arise in this context, the details should be coordinated with the external adviser. It is important for the exercise of rights to record the different stages of the Coronavirus outbreak in a detailed way.

c) Dispute resolution

The parties to the sale and purchase agreement often have different opinions on the question of whether a MAC event exists. The execution of the transaction should, however, not be delayed because the uncertainty as to whether it will be completed will be detrimental to the continuation of the of the business of the company. Therefore, clarifying whether a MAC event exists and what legal consequences are attached to it is of great importance in the interest of both parties. This question depends primarily on the assessment of economic facts. For this reason, an expert arbitrator, who will make a decision which is binding for the parties and who will make it quickly, seems to be the most appropriate. The person can already be named in the company purchase agreement; the period during which he can be called is not very long.

It would take too much time to resolve the MAC event in an ordinary arbitration or court proceeding. An accelerated arbitration procedure (so-called fast-track arbitration), which is provided for in many arbitration rules, still takes about 6 months and, especially in the case of abridged evidence proceedings, carries the risk of the arbitral award being set aside upon judicial review. However, this right may be waived by the Parties in the dispute resolution clause.



In case the acquisition agreement had already been signed the parties could amend such agreement with a view to optimizing the timing for resolving disputes related to the unforeseeable spread of the Coronavirus.

Note: The above information is designed to provide an overview over the most relevant aspects from the perspective of commercial contracts and M&A transactions. Our analysis does not substitute for detailed legal advice in each individual case.

