FAQs on the Coronavirus: Overview on possible impacts of COVID-19 on contractual relationships and legal classification pursuant to German law – 23 April 2020

1. Introduction

The ongoing COVID-19 crisis and the accompanying global governmental restrictions are likely to affect the ability of companies to perform their contractual obligations as well as cause a substantial decline in revenues.

Below we set out typical contractual and key statutory provisions of the German civil law dealing with extraordinary situations such as the COVID-19 pandemic.

As a rule, one should review the relevant contract in detail and assess whether it sets out provisions which address the current pandemic and its consequences. Irrespective of the existence of such provisions, German law contains some general and flexible rules to deal with extraordinary situations. However, any assessment needs to be made on a case-by-case basis taking into account all specific circumstances.

2. Can a party be excused from its contractual obligations due to COVID-19?

The COVID-19 epidemic has resulted in – and may continue to – result in the (temporary) closure of not only hotels and shops but also operating facilities and offices used by a party to a contract to perform its obligations. In addition, a party to the contract may find it challenging to obtain spare parts or transfer people or equipment as required to perform its contractual obligations.

2.1 Force majeure clauses in contracts

Some contracts set out provisions that suspend the obligations of the parties in the event of and for the duration of obstacles to perform which arise from a "force majeure" event. The German equivalent to the French term is "*höhere Gewalt*" (literally "higher force"). The German Federal Court of Justice (*Bundesgerichtshof*) defined the term to refer to:

- external events which do not have an operational/business connection, which
- cannot be averted even by exercising the utmost care that can be reasonably expected.

Generally, a force majeure clause would list those circumstances that can be defined as force majeure and particularly whether or not an event such as COVID-19 qualifies as force majeure. If the clause is unclear, general principles of contract interpretation will be applied to determine the intention of the parties.

Force majeure clauses vary significantly. Many force majeure clauses require a party's reasonable effort to overcome obstacles resulting from force majeure events. Some force majeure clauses only require the parties to consult with each other to determine the course of action to pursue.

As a rule, force majeure clauses do not excuse a party from its obligation to make payments as a consequence of a force majeure event. However, a party is excused from making payments to the extent the other party is excused from performing its obligations.

Up until now, German courts accepted epidemics as a force majeure event when applying travel law. Therefore, it may well be possible that German courts will recognise the COVID-19 pandemic as a form of force majeure.

2.2 Are there any statutory defences available to a defaulting party due to the COVID-19?

Under the German law principle of "impossibility" to perform a contract, a party is not required to perform its contractual obligation if performance is impossible for such party and would be impossible for any other person. Accordingly, a party may only be excused from performing its obligation if it is unable to do so after having (to no avail) tried to source the relevant services, works or goods from third parties. If the contractual obligation can be performed in part, the party may have to perform such part.

The cause of the reason for the default is not relevant, such as it is not important whether the performance is factually or legally impossible or because the passing of time made it impossible.

The affected party, in principle, is finally excused from performing its contractual obligation if it cannot be performed permanently, such as not even at any point of time in the future. However, temporary obstacles may be deemed permanent depending on, for example, the contractual goals, in particular whether or not it would be unreasonable to require the other party to continue to wait until the contract can be performed. This may be the case, for example, with a view to contracts regarding the trade in goods given that the trade business is dependent on short-term dispositions. Courts have considered the impossibility to perform due to the outbreak of a war or revolution to be permanent given that the end of the war or unrest is unforeseeable.

From a current perspective, the closure of operational facilities or the delay of the delivery of goods by third-party pre-suppliers due to the crisis will more likely than not be considered a temporary obstacle. Furthermore, a party may refuse performance:

- to the extent that performance, which in principle would be possible, requires expense and effort that – taking into account the subject matter of the obligation and the requirements of good faith – is grossly disproportionate to the interest of the other party to receive performance; this right to refuse performance only applies in exceptional circumstances; and

- if a party is obliged to render the performance in person and, when the obstacle to the performance is balanced against the interest of the other party, performance cannot be reasonably required.

Please note that none of the foregoing applies to obligations to make payments. Accordingly, the party having the obligation to make payments will not be excused from such obligation on the basis of "impossibility" pursuant to German law. However, a party is exempt to make payment to the extent the other party is excused from performing its obligations.

3. What are the rights of a party if the other party is excused from its obligation to perform?

If a party is excused from its obligation to perform, the other party, in principle, is exempt from making payments to the extent the contract is not performed and may have the right to withdraw from (i.e. rescind) or terminate a contract and claim damages.

3.1 Force majeure clauses in contracts

Generally, force majeure clauses set out that a party does not have to make payments in the event and as long as the other party is excused from performing its obligations.

Depending on the force majeure clause in a contract, the contract may also set out additional provisions dealing with e.g. rights of rescission or termination.

3.2 Statutory rights dealing with the event of an "impossibility" to perform

3.2.1 Payment claims

If a party cannot perform due to impossibility in full or in part, such party cannot claim to be paid for the impossible performance. Consequently, the other party is exempt from making payments.

3.2.2 Termination of the contract

If one party is excused from performing the contract, the other party may withdraw from (i.e. rescind) the contract.

In the event of contracts with continuing obligations (e.g. lease contracts), the party affected by the non-performance of the other party may have a right to terminate the contract for cause with immediate effect.

In the event of a temporary obstacle to perform, and given the circumstances applicable to the specific contract, a party may have to set the other party a reasonable time limit for performance prior to being able to terminate the contract.

3.2.3 Damage claims

A party may only claim damages in case the other party is responsible (i.e. at fault) for the non-performance of its obligations. A party is at fault for its intentional or negligent actions or omitted (where it was required to act). A person acts negligently if he or she fails to exercise reasonable care.

In principle, a party may not claim damages due to a delay during the period of time the other party is excused from performing its obligation.

Please note: parties to a contract are obliged to exchange information relevant to the performance of a contract. In the current COVID-19 situation, the party hindered from performing should inform the other party about existing or foreseeable obstacles that may affect performance. In case such duty is breached intentionally or negligently, the defaulting party must reimburse the other party for the damage caused.

4. Can a party to a contract require that the terms of the contract are adjusted due to the COVID-19 crisis?

With respect to the (temporary) closure of hotels, shops, operating facilities and offices (in whole or in part) and the impact of the COVID-19 crisis on supply chains and the revenue of businesses, one may consider whether or not a right to adjust the contract exists.

4.1 Economics clauses in contracts

If the parties have explicitly agreed on an economics clause, the parties have attached particular importance to the equilibrium of the contractual obligations. A typical example of an economics clause is set out below:

> *"Should unforeseen circumstances arise during the term of the contract, which have substantial economic, technical or legal effects on the contract, for which no provisions have been agreed in the contract or which were not considered when entering into the contract, and should, as a consequence thereof, any contractual provision be unreasonable for a party, the affected party may request from the other party a corresponding adjustment of the contractual provisions, which takes into account the altered circumstances with due regard to all economic, technical and legal effects on the other party."*

The wording of economics clauses differs in detail. However, they generally set out principles similar to the principle of "frustration of contract" (described in more detail below), even though the requirements for an adjustment of the contract are usually lower than when applying the principles of "frustration of contract".

4.2 Principle of "frustration of contracts"

The principle of the "frustration of contract" is set out in the German Civil Code and is based on the general principle of good faith.

Generally speaking, the principle of "frustration of contract" applies to contracts, however, particularly to continuing contractual obligations (e.g. lease contracts) and it aims at adjusting a contract against the background of unforeseen exceptional circumstances. It applies to all contractual obligations, including payment obligations. Therefore, especially parties whose revenue streams are affected by the COVID-19 crisis and who have to make payments pursuant to the contract may want to consider invoking the principle of "frustration of contract".

4.2.1 Payment claims

The principle of "frustration of contract" applies:

- if circumstances that were the basis of a contract have significantly changed since the contract was entered into; and
- if the parties would not have entered into the contract or would have entered into a contract with different content if they had foreseen this change; provided that
- one of the parties cannot reasonably be expected to continue to be bound by the contract without changes to the contract.

However, the principle of “frustration of contract” does not apply if contractual provisions or statutory claims exist which deal with the changed circumstances. Thus, in principle, an adjustment of a contract on the basis of “frustration of contract” is excluded e.g. if and to the extent

- the matter at hand would fall within the scope of a warranty claim;
- the affected party would be excused from its duty to perform due to “impossibility”; or
- statutory provisions exist which have been introduced to deal with hardship situations in contracts (Vertragshilfenrecht). Such provisions were introduced, for example, after the First and the Second World War and allowed the court, given certain conditions, to intervene in existing contracts and restore the balance between the rights and obligations thereunder. The goal was to protect debtors and avoid a massive business collapse.
- if the contract already contains provisions for the lapse, existence or absence of certain circumstances (e.g. economics clauses or force majeure clauses).

4.2.1.1 What is a “significant change” in the “basis of a contract”?

The basis of the contract refers to the mutual expectations of the parties at the time of the conclusion of the contract and the expectations of one of the parties about the existence or the future occurrence of certain events which are recognisable by the other party and which such other party does not object to, provided the intentions of the parties are based on such expectations. It suffices if the parties took the absence or occurrence of events for granted. The basis of every contract is e.g. the concept of the equilibrium of the contractual obligations.

Every contract is based on the expectation that the economic, political and social conditions will not change on a fundamental level. This expectation may be adversely affected in the event of war, displacement, hyperinflation and (natural) disasters as well as fundamental changes in economic, political or social conditions.

In our view, the existence of the COVID-19 pandemic, which comes with numerous official orders and bans that intervene significantly in the social and economic fabric of society, in principle, affects the basis of any contract.

A change is significant if one cannot seriously doubt that at least one of the parties or both would not have concluded the contract in question or would have concluded it with a different content had they known of the change. However, not every drastic change in the circumstances justify an adjustment of the contract. Rather, a contract may only be adapted if continued adherence by the adversely affected party would lead to a result which must be seen as contrary to justice and the principle of good faith.

4.2.1.2 Risk allocation to the parties in accordance with law

In principle, a contract may not be adapted if the significant change is due to expectations or circumstances which fall within the sphere of risks of one party as a matter of principle in accordance with the law and court rulings.

As a rule, the party that can avoid a risk most cost-effectively (cheapest cost avoider) typically bears that risk. This is generally the party that has the power over the asset or service, which is the contractual subject matter. Therefore:

- the owner of an asset has to bear the risk of the devaluation or the coincidental loss of the asset;
- the debtor of a non-cash benefit (e.g. asset, service, right to use) bears the procurement risk and the risk that performance of its obligations has become more difficult;
- the creditor of a non-cash benefit (e.g. asset, service or right of use) bears the risk of the devaluation of such non-cash benefit and the risk that it is suitable for the creditors' aims.

Thus, for example, a lessee of a lease object bears the risk that the monetary value of the rent paid is higher than the value of the right to use the leased object. The lessee also generally bears the risk that it can generate profits using the leased object (for example, commercial premises).

Similarly, an investor bears the risk of an economic failure and the entrepreneur bears the entrepreneurial risks, such as a change in demand. If there is some element of speculation by a party regarding the occurrence of events in the future, the principle of "frustration of contract" is not applicable either.

With regard to cash benefits:

- the creditor bears the risk of inflation; and
- the debtor bears the risk of financing.

Please note that a debtor, in principle, cannot invoke the principle of "frustration of contract" for the reason of its insolvency.

Against the background of the world wars and their aftermath, courts did not allocate the risk in accordance with the general principles set out above. For example, after World War II in relation to lease agreements for (partially) destroyed property, the German Federal Court of Justice ruled that the owner of partially destroyed apartments was excused from its obligation to maintain the rental space because the costs for the necessary restoration was deemed unreasonably high. The Hamburg Higher Regional Court (*Oberlandesgericht*) ruled that the lease agreement for a telephone system was suspended given that the system had been destroyed by bombs and that the parties were to share the loss. This may serve as an example that there are no clear rules regarding the risk allocation between the parties to a contract.

In the context of the COVID-19 crisis one would have to consider the various bans and orders issued by the authorities and their impact on the business of parties directly affected by such bans and orders and of parties only indirectly affected by the COVID-19 induced economic problems and downturn. It is open to argument at least that this crisis is an exceptional event whose impacts may not have to be solely borne by one contract party.

4.2.1.3 Foreseeability

A party which foresaw or ought to have foreseen that the circumstances or events giving rise to the significant change bears the according risk. In light of the SARS virus (2002 / 2003), the H7N9 bird flu (2007) and the risk analysis "pandemic" of the German Federal Government (2012), it can be expected that the question of foreseeability will be raised by any defendant in court or arbitration proceedings.

In our view, it is more likely than not that a German court would hold that the COVID-19 crisis and its ramifications were unforeseeable for any contract concluded before first warnings of a global spread had to be noticed. However, it is questionable whether a party could rely on the principle of "frustration of contract" in relation to a contract concluded (or amended) as from January/February 2020. The explanatory memorandum to the draft of the German Act of 27 March 2020 in reaction to the coronavirus crisis (see below) set out the understanding that the pandemic spread of COVID-19 was not foreseeable by the general public prior to 8 March 2020 and that contracts concluded thereafter were concluded in the knowledge of a possible imminent far-reaching change in economic life.

4.2.1.4 Foreseeability

The parties to a contract may provide for a risk allocation scheme, which is different to the one pursuant to law.

This would be the case if the party not being affected by a significant change has assumed some responsibility or risk in this regard. For example, if the projected turnover of a shop has been taken into account when calculating the rent to be paid, the lessor has assumed at least some risk of a downturn of the shop's business.

4.2.1.5 Limits of the assumed risk

Even if the risk is in principle allocated in whole or in part to only one party, the principle of "frustration of contract" may apply if the limits of such assumed risk are exceeded.

In this respect, courts use the term "limit of economic sacrifice" (*Opfergrenze*). However, there are no clear rules to determine such limit. An analysis of the case law shows that the circumstances of the individual case must always be taken into account.

4.2.1.6 Further criteria for the assessment of (un)reasonableness

There are no clear criteria for assessing whether or not the continuation of a contract without change is unreasonable for the affected party in a specific case. Rather, the principle of "frustration of contract" requires an in-depth analysis of each individual case, e.g.:

- The longer the COVID-19 situation lasts and a party is unable to generate the income that is essential to fulfil the payments pursuant to the contract and cover other costs, the less reasonable it may be for the affected party to continue to be obliged to adhere to an unchanged contract.
- The German Federal Court of Justice ruled that it would be unreasonable if the continuation of the contract would pose a threat to the continued existence of a tenant.

4.3 Legal consequences

The modalities of a contract adjustment depend on the individual case. The goal of the principle of "frustration of contract" is to readjust the balance of the parties' interests with the least possible interference with the original arrangement. Since the adaptation of a contract is an exception to the principle of the sanctity of contracts (pacta sunt servanda), the courts generally set high thresholds for the adaptation of a contract.

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Contract adjustment is generally granted for the future only. In principle, the relevant point in time for the adjustment, therefore, is the day of the receipt of the request for adjustment by the other party. The right to state a claim in relation to the adjustment of a contract may be lost for all payments made prior to stating such claim. Therefore, even if a party solely wants to safeguard its rights, it will have to issue a demand for an adjustment, referencing the COVID-19 crisis. Payments made after the request for adjustment has been sent should only be made with the provision that they may be subject to a claim for repayment.

5. Can a party to a contract require that the terms of the contract are adjusted due to the COVID-19 crisis

The German Act of 27 March 2020 on the mitigation of the consequences of the COVID-19 pandemic in civil, insolvency and criminal procedure law ("Act") sets out some specific provisions against the background of the COVID-19 pandemic applicable to

- lease agreements pertaining to real estate or rooms; and
- consumers and micro-enterprises

According to the Act, a landlord may not terminate a lease contract pertaining to real estate or rooms on the sole ground that the tenant fails to pay the rent in the period from 1 April 2020 to 30 June 2020 if the failure to pay is due to the effects of the COVID-19 pandemic.

Until 30 June 2020, consumers and micro-enterprises within the meaning of the Decision of the Commission concerning the definition of micro-enterprises and the small and medium-sized enterprises (2003/361/EC of 6 May 2003) have the right to refuse performance pursuant to certain material contracts setting out continuing obligations, which were entered into prior to 8 March 2020, if due to the COVID-19 pandemic:

- this would endanger the reasonable standard of living of consumers or their dependants; and
- performance is not possible for micro-enterprises or performance would endanger their economic foundations.

Claims for repayment and interest falling due between 1 April 2020 and 30 June 2020 arising from consumer loan agreements entered into prior to 15 March 2020 are deferred by three months if the consumer suffers a loss of revenue due to the COVID-19 pandemic which would make payment unreasonable for the consumer, particularly if it would endanger the reasonable standard of living of the consumer or its dependants. Furthermore, consumer loan agreements may not be terminated due to such delayed payment or a substantial deterioration of the financial circumstances of the consumer or the recoverability of collateral provided.

Please note:

- the Act also sets out reasonableness tests to protect the other party;
- the time limits referred to above may be extended; and
- whether or not courts may arrive at the conclusion that the Act excludes the application of the principle of “frustration of contracts” (please see above) within its scope of application, remains to be seen.

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