Impacts of COVID-19 on the Performance of Contracts Under German Law

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Key Messages:

- COVID-19 constitutes a Force Majeure event if
  - epidemics or pandemics are expressly provided for in the agreement as qualified Force Majeure circumstances and
  - if acts or orders of the German government including travel restrictions, quarantines or border closures have been issued.
- However, if the risk of unforeseen events like the COVID-19 pandemic is fully attributed to one party in the agreement, such party might not be entitled to request an adjustment of the terms of the agreement, or to terminate the agreement, and might even be held liable for the damages caused by the non-performance under German statutory law.

Recommendations for Manufacturers, Suppliers, Tenants and Service Providers to Prevent a Liability in Connection with COVID-19-Related Non-Performance

- Review whether the timely performance of services has actually become objectively impossible.
- Review your contractual relationships for the existence and structure of (i) information requirements, (ii) guarantees, (iii) "Force Majeure" clauses and (iv) no-fault contractual penalties or other sanctions.
- Inform your contractual partners in good time about impending service failures and delays.
- Early contact with your contractual partners may create a constructive environment and solutions for both sides.
- Do not prematurely assume that you are no longer obliged to provide services.
- Adopt and document all operational precautions to mitigate COVID-19 and maintain your business operations.
- Always differentiate between whether hindrances to performance were actually created by Force Majeure, or whether business decisions alone caused a hindrance to performance.

1. Release from Performance Obligations Under Force Majeure Clauses

When contractual obligations become impossible or impracticable, Force Majeure clauses can form a contractual basis to be excused from the performance of obligations in case certain events or circumstances occur and determined conditions are met. Whether or not the COVID-19 constitutes a Force Majeure event needs to be determined on a case-by-case basis. Primarily, it depends on the language and drafting of the respective Force Majeure clause, which defines the scope of the Force Majeure clause.

Generally, Force Majeure events are exceptional external events that have no operational connection with the contractual obligations and are beyond the parties' control. Typically, Force Majeure clauses list specific events that would qualify as Force Majeure, among others war, terrorism, natural disasters or governmental acts are frequently referred to.

In case epidemics or pandemics are expressly stated as Force Majeure events, COVID-19 is certainly in scope of the clause. Consequences of COVID-19 may also be in scope through governmental orders or acts such as travel restrictions, quarantines or border closures.

Where the parties have not expressly listed typical Force Majeure events, or if an existing list does not expressly include epidemics or pandemics, the scope of the clause is subject to the interpretation of the clause. In addition, it is important to consider whether both parties are entitled to invoke the Force Majeure clause, or whether the clause is drafted unilaterally to the benefit of only a specific party.

If the Force Majeure clause comprises epidemics or pandemics, a party can be released from contractual obligations if certain further requirements are met: (i) a causal relationship between the COVID-19 pandemic and the performance disruption is required; (ii) the party had no control over the circumstances leading to its inability to perform the contractual obligations; and (iii) the prevention or mitigation of the COVID-19 pandemic and its consequences could not have been reasonably expected from the party. Generally, Force Majeure clauses also concretely specify the legal consequences in case of the occurrence of a Force Majeure event (e.g., prevention of performance, default, etc.).

The party claiming to be excused from performance based on a Force Majeure event bears the burden of proof for the occurrence of a Force Majeure event and with regard to the alleged legal consequences, i.e., potentially the release from certain performance obligations. In addition, requirements with regard to formalities (e.g., notification obligation) set forth in the contract for relying on Force Majeure must be observed.

2. Potential Release from Performance Obligations under German Statutory Law

A party to an agreement that is affected by the COVID-19 pandemic might further be released from its contractual obligations under provisions of German statutory law.

2.1 Release from Performance Obligations Due to Impossibility of Performance Caused by the COVID-19 Pandemic (Section 275 of the German Civil Code)

If it is completely impossible for a party to comply with a contractual obligation, under German law such a party is generally released from its obligation to perform the respective obligation. In case of impediments caused by COVID-19, in certain cases it might not be completely impossible for a party to comply with its obligations, but the required effort involved would have increased extremely.

In such cases, however, if compliance with a contractual obligation would require unreasonable effort, a party can be no longer bound by certain contractual obligations (Section 275 para. 2 of the German Civil Code).

Determining whether a party is actually released from its performance obligations depends on the concrete circumstances of the individual case, including: (i) the content of the obligation, (ii) the requirement of good faith; and (iii) whether or the debtor is responsible for the hindrance to performance.

Furthermore, the burden of proof for the impossibility of the performance as well as the possibility to perform only with an unreasonable effort falls upon the party relying on these circumstances.

2.2 Adjustment of the Contract Terms on the Basis of the Principle of Frustration of Contract (Section 313 of the German Civil Code)

Further with regard to impediments caused by the COVID-19 pandemic, a party can get released from performance obligations on the basis of the concept of Frustration of Contract.

If certain factors that were the basis and motivation for the parties to enter into an agreement significantly change subsequently, and if the parties would not have entered into the agreement at all or only at different terms if they had foreseen such changes to such circumstances, the affected party can request adjustment of the terms of the agreements if such party cannot be expected to adhere to the existing terms of the agreement (Section 313 para. 1 of the German Civil Code).

In extreme situations, an affected party can even withdraw from the contract in case of a profound change of circumstances.

The negative impact of COVID-19 can – on an individual basis – lead to a frustration of contract, particularly if the actual value and the involved efforts between service to be provided or products to be delivered are no longer appropriately reflected by the remuneration or purchase price to be paid by the other part, and if such disruption is not within the scope of risk of one contractual party.

Generally the negative effects of the COVID-19 pandemic on certain industries are so dramatic that parties which are no longer able to comply with their obligations under service or purchase agreements can request adjustment of the terms of their contract in order to accommodate the impediments caused by COVID-19.

However, a party would not be entitled to request adjustment of the terms of the relevant contract on the basis of the principle of Frustration of Contract if the relevant contract would fully attribute the risk of negative impacts of unforeseen events like the COVID-19 pandemic unilaterally to the respective party. In this regard, it would still be subject to the review of the contract in the individual case whether it comprises such a unilateral allocation of risks like the COVID-19 pandemic.

2.3 Article 79 of the UN Convention on the International Sale of Goods ("CISG")

According Art. 79 CISG a party is released from liability for a breach of contract if it can prove that the non-performance resulted from Force Majeure, thus, an unavoidable event that was beyond the parties' control and its consequences could not have been reasonably prevented or mitigated (e.g., governmental acts such as import or export bans; Article 79 para. 1 of the CISG).

In this respect, if a party is prevented from duly performing its obligations under an agreement which is subject to the provisions of the CISG due to the effects of the COVID-19 pandemic, generally, such party can be released from its performance obligations under Article 79 of the CISG.

It would however be subject to review in the individual case to which extent the concrete inability to comply with the contractual obligations was actually caused by the COVID-19 pandemic and whether these effects could have been prevented or at least mitigated in any way.

In case of supply chains, i.e., if a retailer is not able to comply with its delivery obligations due to the fact that its own sub-supplier (e.g., the producer) is not able to supply the relevant products due to the COVID-19 pandemic, the retailer can be released from its delivery obligations on the basis of Article 79 of the CISG (Article 79 para. 2 of the CISG).

A party which is affected by the COVID-19 pandemic and which is therefore, released from its performance obligations pursuant to Article 79 of the CISG cannot be held liable by its contractual partner for damages caused by the respective non-performance (Article 79 para. 5 of the CISG).

3. Risk of Damage Claims in Case of Non-Performance of Contractual Obligations

Under German law, as a general principle, if one party does not fulfil its contractual obligations and the other party suffers a damage originating from such breach of contract, the party in breach may be held liable towards the other party with damage compensation claims (Section 280 para. 1 of the German Civil Code).

The party which has suffered the damage is not entitled, though, to reimbursement of the damages if the non-performing party did not culpably breach the respective contract (i.e., no intentionally and not in negligence).

A party which is prevented from duly performing an agreement due to effects from the COVID-19 pandemic could generally and subject to review of the individual circumstance argue that it did not culpably cause the non-performance.

However, each party would be required to mitigate the damages and to adhere to secondary obligations (*vertragliche Nebenpflichten*), i.e., a party which is prevented from duly performing its obligations due to COVID-19 can would still have to inform its contractual counterpart as soon as possible of the impediments to due performance and take further appropriate measures to remain in the position to duly perform its obligations and to prevent damages to the other party.

4. Extraordinary Termination of Long-Term Agreements (*Dauerschuldverhältnisse*)

Parties to a long-term service or supply agreement who are affected by the COVID-19 pandemic might be interested not only to adjust certain terms of their agreement, but to terminate the complete agreement.

Under German law, each contractual party to a long-term agreement may terminate the agreement if such party can reasonable not be expected to further adhere to the agreement until the agreed end or until the expiry of a notice period (termination for cause; *aus wichtigem Grund*) subject to the provisions of Section 314 of the German Civil Code.

However, the requirements for an extraordinary termination of a long-term agreement might not be met even in case one party if prevented from duly performing its obligations due to the COVID-19 pandemic with regard to the fact that pursuant to legal practice of the German Federal Court (*Bundesgerichtshof*), the reason for the termination must originate from the risk area of the contractual partner of the party planning to terminate the agreement.[1]

Thus, encumbrances to duly deliver products or to provide services due to COVID-19 do generally not entitle a party to terminate the agreement as a whole pursuant to Section 314 BGB since the sole existence of the COVID-19 pandemic cannot be allocated to either of the parties.

[1] BGH NJW 2013, 2021.

Instead of terminating the long-term agreement as a whole, the party which is affected by the COVID-19 pandemic and which is unable to duly perform its obligations under a long-term agreement might be released from its performance obligations under Section 275 of the German Civil Code or it might be entitled to request an adjustment of the terms of the agreement pursuant to Section 313 of the German Civil Code (both as described above).

5. Rent Reduction and Adjustments to the Terms of Lease Agreements Due to COVID-19

At the present stage of the COVID-19 pandemic, which requires physical distancing, many restaurants, bars, hotels and similar places are and avoided by customers and remain deserted. If the respective premises are subject to a lease the respective lessee will suffer significant loss of income and might be interested in reducing the rent or to adjust the terms of the lease agreement with regard to the obstruction of business caused by the epidemic.

5.1 General Concept of German Leasing Law

However, generally under German leasing law, the lessee can be entitled to a rent reduction or to an adjustment of contract terms only under specific circumstances:

Pursuant to Section 536 of the German Civil Code, the tenant may be entitled to reduce the rent if the leased property has a defect that invalidates its capability of being used in accordance with the lease agreement.

Subject to the terms of the lease agreement in the individual case, COVID-19 and the resulting collapse in demand will probably not be classified as a defect of the leased property, since the leased property remains usable without restriction – only the demand for it has fallen drastically.

The landlord is only obliged to provide the tenant with the right of use of the leased property in return for payment of the rent. The tenant is generally and subject to the provisions of the agreement not obliged to use the lease object in any specific way. In this respect, the obligation rent payment obligation is only linked to the right of use of the leased property – and not for the usage itself. Subject to the concrete provisions of the lease agreement, if the tenant intends to offer the leased premises to the public as a hotel, restaurant or bar, the risk whether there will actually be customers visiting the premises is generally the tenant's risk.

Thus, in case the usage of the leased property is limited due to reasons originating from the tenant's sphere of risk, like the absence of customers due to the COVID-19 pandemic, the tenant remains generally obliged to rent payments.

5.2 Public Orders Prohibiting the Intended Use Under a Lease Agreement

The German government has issued General Rulings (*Allgemeinverfügungen*) prohibiting amongst other things the further operation of restaurants, hotels and other non-critical businesses.

If the lease agreement provides that the premises are leased for the purpose of the operation of a restaurant, bar or hotel or similar location, and if subject to the interpretation of the agreement the landlord bears the risk that the premises can actually be used for such agreed purpose, the tenant might be entitled to reduce the rent payments on the basis of Section 536 of the German Civil Code with regard to the prohibition of the intended use by the General Rulings.

Further, if the tenant was forced to temporarily abandon the leased property due to COVID-19 and the General Ruling, the tenant might be entitled to request a rent reduction with regard to expenses and benefits saved by the landlord (operating, maintenance and repair costs).[2]

5.3 Frustration of Contract (Section 313 of the German Civil Code)

Particularly in cases of lease agreements providing for a turnover- or profit-related rent, the tenant might be entitled to request an adjustment of the terms of the lease agreements (e.g., on a deferred or a reduced rent payment plan) with regard to the severe negative effects of COVID-19 pursuant to the principles of Frustration of Contract (*Störung der Geschäftsgrundlage,* Section 313 of the German Civil Code; pls. refer to section 2.2 above). In the event the parties agreed on such variable rent – and not on a fixed rent – the landlord participates in the tenant's risk of use of the leased property. Thus, the tenant and also the landlord would potentially have agreed on different terms if they had foreseen such a scenario in the time when they concluded the lease agreement – a correction pursuant above principles would be not excluded.

2 MüKoBGB/Bieber BGB § 537 Rn. 7, 8.

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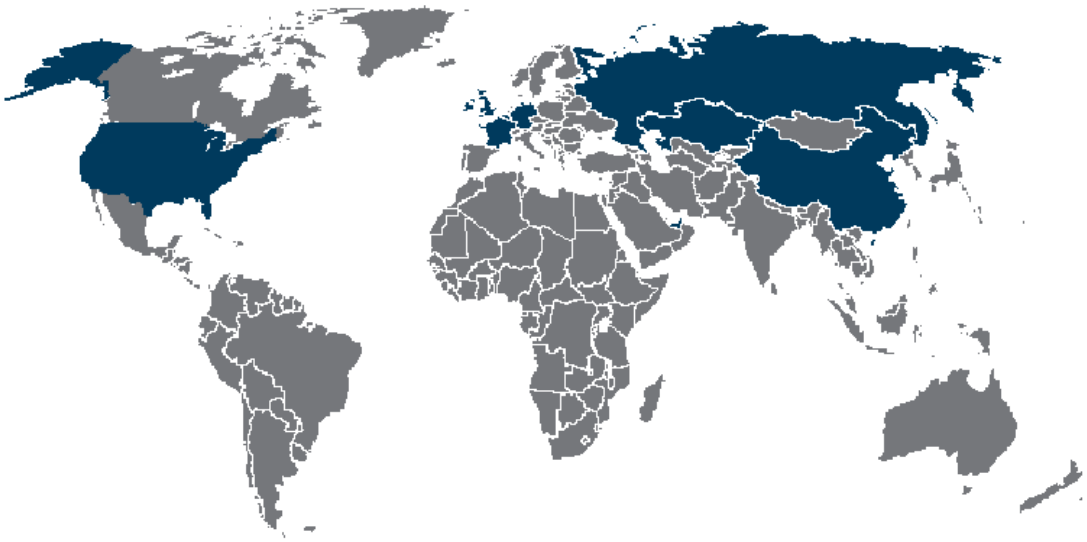

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