LEGAL UPDATES: COVID-19

IN ALLIANCE WITH Pepper Hamilton LLP

Effects of Covid-19 on contracts regulated under Italian law: *force majeure* - *factum principis* - renegotiation

A. INTRODUCTION

The ongoing health emergency declared by the WHO on March 11, 2020 required the adoption by the Italian Government – and not solely - of extraordinary measures to contain the contagion.

These measures have triggered very severe implications on the entire economy with the immediate lockdown of production activities, hotels, the cancellation of most air traffic and the ban on movement of people.

It is undeniable that the Covid-19 outbreak and the associated health emergency are extraordinary, unexpected and unforeseeable events. The result is a reflection on the renegotiation of existing contracts such as lease agreements, contracts for the provision of services and goods, supply agreements, procurement, etc..

To this aim, it is useful to examine the emergency regulations, as well as the Italian Civil Code ("**ICC**") provisions, in order to assess whether or not the circumstances under which the debtor can invoke the exemption from liability for non-performance exist and, therefore, it is proposed to concretely investigate the notion of *force majeure* and the *species* of the so called *factum principis* (in this case, emergency regulations) as causes of exemption from liability.

Thus, also to evaluate in a detailed and factual manner the renegotiation of existing contracts.

Moving forward with order.

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B. *FORCE MAJEURE* AND *FACTUM PRINCIPIS* - EFFECTS AND CODICISTIC REMEDIES: OCCURRED IMPOSSIBILITY AND EXCESSIVE ONEROUSNESS (*HARDSHIP*) OF THE PERFORMANCE.

The ICC does not offer a definition of *force majeure*, which is instead elaborated by the case law that qualifies it as an extraordinary, unexpected and unforeseeable event, extraneous to the debtor's legal sphere and that cannot be overcome with the use of ordinary diligence. The concept identified by the case law has a broad scope and includes natural disasters and civil wars (and also archaeological findings for what concerns the specific field of procurement[1]).

Force majeure is often referred to in arbitration case law on contracts, in particular to exclude that the simple hypothesis of lack of finance can be traced back to this case[2].

[1] Trib. Firenze; 22/05/2019, n. 1581; Cass. Civ., sez. I, Ord.., (hear. 28-01-2020) 19-03-2020, n. 7463 "... *The case law of this Court, with reference to a similar case, has repeatedly stated that the discovery of archaeological finds underground (so-called "archaeological surprise") is a cause of* force majeure*, within the meaning of Presidential Decree no. 1063 of 1962, art. 30, paragraph 1, which prevents the continuation of the works in fulfilment of the duties imposed by law and without any discretion on the part of the client (Section 1, no. 2316 of 05/02/2016, Rev. 638579-01; Section 1, no. 3670 of 17/02/2014, Rev. 629723-01; Section 1, no. 10133 of 14/05/2005, Rev. 582195-01).*

[2] The arbitration case law formed in the field of public contracts, in particular contracts, according to which the lack of finance does not justify the suspension of the contracted works, therefore, does not exempt the Customer from the

Accordingly, it is not uncommon for the parties to insert in their contractual practice a definition of *force majeure*, which takes the form of extraordinary, unforeseeable and unforeseeable events which are in any case inherent the subject-matter of the contract and the service inferred from it[3].

The circumstance is rather relevant, since such definitions given in the contract are added, rendering the concept more specific, but do not fully replace the notion of *force majeure*.

In this context, another hypothesis of exoneration of liability is the figure of *factum principis* - *species* of the *genus force majeure* - which occurs when a legislative or authoritative measure implemented prevent the performance of the service.

The causes of *force majeure* and their consequences in terms of the regulation of obligatory relationships is important because they can determine the total or partial impossibility to render the service, or the excessive onerousness (*hardship*) of the service itself, and the ICC generally regulates its effects.

As for the impossibility to render the benefit, the consequences are governed, in particular, by:

(i) Article 1256[4] of the ICC, which provides for the extinction of the obligation when the debtor's performance becomes impossible for reasons that cannot be referred to him, and the debtor's exemption from liability where the impossibility is temporary, for the entire duration of the impossibility;

(ii) Art. 1218 of the ICC which, by regulating the non-performance of the obligation, exonerates the debtor from damages where it proves that the non-performance or delay was caused by the impossibility of performance resulting from a cause not attributable to it.

(iii) Art. 1463[5] of the ICC, within the framework of bilateral contracts, provides that the party freed from the impossibility of rendering its performance cannot request the counter-performance and must return the one already received according to the rules of undue payment[6];

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compensation due, this because the lack of financial means constitutes a violation of the obligations incumbent on the contractor, including that of placing him in the legal condition to perform the work. Arbitration award, 29 October 2013; Arbitration award, Rome, 14/05/2010 n. 68; 7/07/2010 no. 93; 27/12/2007 no. 170 and 26/07/2006 no. 33; Arbitration award, Rome, 14/12/2010 no. 160; 30/11/2004 and 25/11/2003 no. 131, in www.appaltieriserve.it.

[3] Arbitration award 27/28 September 2018, Arbitral Tribunal Proff. ri L. Salvaneschi, M. Zaccheo and A. Tedoldi.

[4] Art. 1256 ICC *"... the obligation is extinguished when, for a reason not attributable to the debtor, performance becomes impossible. If the impossibility is only temporary, the debtor, as long as it lasts, is not responsible for the delay in performance. However, the obligation is extinguished if the impossibility persists as long as, in relation to the title of the obligation or the nature of the object, the obligor cannot be considered to be obliged to perform or the obligee no longer has an interest in performing it..."*.

[5] Art. 1463 ICC *"... the party freed due to the impossibility to provide the service due cannot ask for the counter-performance and must return what it has already received, according to the rules relating to the recovery of undue payment..."*.

[6] Civil cassation, Section III, 29/03/2019, no. 8766 "... *With regard to the termination of the contract, the impossibility of rendering its performance can be configured if the performance of the service by the debtor or its use by the other party has become impossible, provided that this impossibility is not attributable to the creditor and his interest in receiving the service has ceased, in which case it must be noted that the essential purpose of the contract can no longer be achieved, with the consequent extinction of the obligation. (In application of the principle, the S.C. rejected the appeal brought against the judgment which had deemed the debtor freed from the performance to be impossible - in this case, the performance of an opera in the open air which, even after the execution of the first act alone, had been interrupted due*

(iv) Art. 1464 of the ICC[7], which provides for the possibility for the performing party to reduce its performance due to the partial impossibility of the counter-performance, or to withdraw from the contract.

The occurred impossibility is not represented by that burden that derives from a greater complexity of the performance or from its increased onerousness, but rather resides in a situation that has arisen, which prevent the performance, that cannot be overcome with the diligent effort to which the debtor is bound in the light of the principle of good faith[8].

The hypothesis of *force majeure* that makes performance impossible entails the debtor's exemption from liability.

With particular reference to the sub-species called *factum principis*, according to the Supreme Court it does not operate "automatically" as an exemption from liability. Hence, because the debtor is in any case obliged to prove that the order or prohibition of the authority was decisive in causing the default[9] and that it can be configured as an event totally extraneous to the will of the obligor and to any of his obligations of ordinary diligence[10], except in the case of general duties imposed *ope legis* which by definition are not attributable to the debtor[11].

In court, therefore, the judge is called to investigate the fault of the debtor in determining the issuance of the order of the authority in application of the criteria prescribed by Articles 1218 and 1256 of the

to serious adverse weather conditions - with the exclusion for the freed party of the possibility to request the counter-performance and the obligation to return the performance already received).

[7] Art. 1464 c.c. "*... when the performance of one party has become only partially impossible, the other party is entitled to a corresponding reduction of the performance due by it and may also withdraw from the contract if it has no appreciable interest in partial performance...*".

[8] Cass. Civ., section II, 30/04/2012, no. 6594.

[9] Cass. Civ., Section I, 21/11/1986, no. 6856 *"... Nor is it helpful to plead the cause of* force majeure *caused by the shutdown of the supermarket for about a month, including the period immediately before the Easter holidays... the damage caused by the unfair closure of the supermarket had not been decisive, but had only aggravated an already considerable collapse dating back a few years earlier*".

[10] Civil cassation, Section III, 10/06/2016, no. 11914 *"... This Court, in relation to the case in which an event that negatively affects the implementation of the mandatory relationship, may be considered suitable to justify the non-performance or delay in the performance of the service, has held that in the case of the so-called* factum principis, *the debtor must be held liable where the debtor has culpably caused it (see Cass. Civ., no. 21973/07). This is because the* factum principis *is not sufficient, in itself alone, to justify the non-performance and to release the defaulting party from any liability. In order for this extinguishing effect to be produced, it is necessary that the order or prohibition of the authority can be configured as a fact totally extraneous to the obligor's will and to any of his obligations of ordinary diligence, which means that, in the face of the intervention of the authority, the debtor must not remain inert or place himself in a position to submit to it without remedy, but must, within the limits marked by the criterion of ordinary diligence, test and exhaust all the possibilities offered to him to overcome and remove the resistance or refusal of the public authority (thus, Court of Cassation no. 21973/07. n. 818/70). Moreover, in the event that the debtor has not fulfilled his obligation within the contractual terms, he cannot invoke the impossibility of performance with reference to a measure of the administrative authority that could reasonably have been foreseen according to common diligence (Court of Cassation, Sentence no. 2059 of 23/02/2000) ...*"; Court of Cassation, Section II, 30/04/2012, no. 6594; Court of Cassation, Section III, 19/10/2007, no. 21973. In the same sense also in arbitration case law, ANAC Award no. 55/2008 of 29/04/2008.

[11] Civil cassation, Section II, 30/04/2012, no. 6594 *"... Otherwise in the case of duties imposed by law (as in the case of the so-called archaeological surprise, which prevents the continuation of the work without any discretion on the part of the client or contractor: cassation no. 10133/05; or the impossibility* per factum principis *of the performance of tasks by the employee: cassation no. 12719/98 and 7263/96), whose prohibitions are not attributable to the debtor ...*".

ICC and the determination of unforeseeable circumstances or *force majeure* that prevent the performance is left to the discretion of the judge[12].

It constitutes a different case when the performance can actually be fulfilled because it is not expressly prohibited by the restrictive measures, but the other party no longer has an interest in receiving it, due to the negative consequences generated on the market, to name one, the containment measures adopted by the legislation. In this specific case, tribunals have created the figure of the "impossibility to receive the performance", which qualifies as a further cause of termination of the contract - in addition to the impossibility to fulfil the performance - also that of receiving it. It is a principle, now consolidated in the case law of the Supreme Court, that not only the total impossibility to fulfil the performance integrates an automatic case of extinction of the obligation and termination of the contract which constitutes its source, but that the same effects is also achievable through the figure of the "impossibility for the creditor to use the performance"[13].

As for the excessive onerousness of the contract, art. 1467 of the ICC allows the termination of the contract "... *with continuous or periodic performance or with deferred performance if the performance of one of the parties has become excessively onerous due to the occurrence of extraordinary and unforeseeable events, to the party who must fulfil it ...*" [14].

Requirements for the applicability of the instruments are: (*i*) the existence of a contract with continuous, periodic or deferred performance; (*ii*) an alteration of the contractual balance due to an event subsequent to the conclusion of the contract, which is extraordinary and unforeseeable; (*iii*) that one of the two performances has become, as a result of the aforementioned event, excessively onerous.

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[12] Cass. Civ., section II, 30/04/2012, no. 6594 *"... the ascertainment of the fortuitous event or* force majeure *determining a binding situation that prevents the fulfilment of the obligation, involves a factual assessment left to the discretion of the judge of the merits, whose belief, if congruently motivated and immune from logical and legal errors, is not subject to criticism when it comes to legitimacy (see (see Cases Nos 21973/07, 1774/89, 2189/75 and 3602/74) (...) The criterion of the decision, in cases of this kind, in which it is a question of comparing the impossibility of performance on the basis of the facts of others and the fault of the person liable, has been repeatedly indicated by this court in its predictability. It was decided, in fact, that the contractor could not assume, as a cause of* force majeure, *the event which was reasonably foreseeable when the contract was concluded (Court of Cassation 23 February 2000 No 2059; 28 November 1998 No 12093; 5 June 1976 No 2046; 7 January 1970 No 44; 24 June 1968 No 2105). With regard to this teaching, which is still relevant today, it should only be added that predictability is a necessary element of the fact, the assessment of which is reserved to the judge on the merits, and must be carried out with specific and punctual reference to the case before him...".*

[13] In this sense, the Supreme Court has stated that *"the termination of the contract due to the impossibility of performance pursuant to Article 1463 of the Italian Civil Code can be invoked by both parties to the mandatory synallagmatic relationship since the withdrawal from the contract does not depend on the free will of the parties, but is due to unavoidable and totally unforeseeable causes of* force majeure" (Cass. Civ., 10 July 2018, no. 18047; in the same sense Cass. Civ., 20 December 2007, no. 26958).

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C. COVID-19 EMERGENCY REGULATIONS - EXONERATION OF DEBTOR'S LIABILITY FOR *FORCE MAJEURE - FACTUM PRINCIPIS*

In addition to the above referred ICC provisions governing the exemption from liability of the debtor, it is crucial to list Article 91 of Decree Law no. 18 of March 17, 2020, entitled "*Provisions on delays or breach of contract resulting from the implementation of measures to contain and anticipate the price of public contracts*", under which "*... In Article 3 of Decree Law no. 6 of February 23, 2020, converted with amendments by Law no. 13 of March 5, 2020, the following is inserted after paragraph 6: "6-bis. Compliance with the containment measures set forth in this decree is always assessed for the purposes of excluding, pursuant to and for the purposes of articles 1218 and 1223 of the Italian Civil Code, the debtor's liability, also with regard to the application of any forfeiture or penalties connected with delayed or omitted performance ...*".

The above provision crystallizes a specific hypothesis of exclusion of the debtor's liability in case of non-fulfilment of its performance, whether it depends from the compliance with the mandatory containment measures provided by the decree and by the measures issued in execution of it.

The containment measures comprehend those imposing **the lockdown of production activities that are not included in the list attached to the Prime Ministerial Decree of 22 March 2020 and subsequent amendments and additions**.

The special legislation, therefore, typifies the *factum principis* as the cause **justifying** the debtor's exemption from liability, providing that the debtor is not liable when he has been unable to render the performance due to the obligations imposed by the emergency legislative measures.

This is also in consideration of the fact that the decree draws its source from an event such as the pandemic officially declared by the WHO, which certainly meets the requirements of *force majeure*.

The emergency decree introduces a "cause of justification" that operates *ex post*, since the fulfilment of the performance by the debtor would be abstractly due and possible, but it is not practically due to the legislative measures, thus, because of the *factum principis*.

The concerned provision postulates that the exemption from liability can be invoked only by **companies that cannot carry out productive activities**, because they are directly affected by the prohibition. As for the companies whose activity is not prevented - but which, for example, are impacted as well as a consequence of the fact that they operate in the same production chain - in order to benefit from the liability's exemption provided for by the special legislation, it is considered that they are burdened with proof of a direct and absorbent causal link deriving from operating in a market which is directly affected by the prescribed measures of containment precisely introduced to deal with an event attributable to the case of *force majeure* and which was unforeseeable at the time of signing the contracts.

Companies falling under the regulatory provision must, therefore, rely on the remedies set forth in the ICC; and it is then that the notion of *force majeure* comes into play as a prerequisite for the exemption from liability to be found in the exceptional, extraordinary, unexpected and unforeseeable event of the health emergency itself, which rendered the performance impossible or excessively expensive.

Is it possible to claim, **by way of exception**, the impossibility to fulfil the performance by inferring the Covid-19 pandemic as a cause of *force majeure*? It is certainly possible, but it is clear that companies relaying on it, shall prove that because of the occurrence of the *force majeure* event, it is occurred the impossibility to use the performance[15].

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The aforesaid art. 91 of Decree Law no. 18 of 17 March 2020, establishing the debtor's exemption from liability, expressly mentions only articles 1218 and 1223 of the ICC, which deal with the compensation of damages. The fact that only 2 articles are indicated, raises the question about the possible extension of the emergency provision also to art. 1224 of the ICC, concerning the obligation to pay interest from the day of default, even if they were not previously due and even if the creditor does not prove to have suffered any damage.

Well, on this regard, the case law of the Supreme Court helps, in fact, according to it late payment interests provided for by art. 1224 of the ICC is linked to art. 1218 of the ICC, namely the non-fulfilment, with the consequence that the defaulting debtor can be exempted from liability for the delay only when he proves that it was due to a cause not attributable to him[16]. Therefore, the exemption from liability provided for by art. 91 of Decree Law no. 18 of 22 March 2020 which expressly mention art. 1218 of the ICC, is the prerequisite for the exclusion of liability also with reference to art. 1224 of the ICC.

Regarding the predictability of the damage referred to in art. 1225 of the ICC, which prescribes that the compensation for damages is limited to what could have been foreseen at the time the obligation arose, if the breach does not depend on the debtor's wilful intent or gross negligence. Although, not expressly mentioned in the concerned provision, it is considered that a debtor can enjoys the effects of this provision whether the breach actually derives from the observance of emergency measures, given the absolute unpredictability of the damage that could have occurred due to an equally extraordinary, unforeseen and unforeseeable event, such as the pandemic and the consequent *factum principis*.

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With regards to contractually agreed penalties and the effects on them of art. 91 Decree Law no. 18 of 17 March 2020, as mentioned above, the text states that compliance with the containment measures also exempts the debtor from the obligation to pay penalties for delayed or omitted performance.

On this regard, the function of a penalty clause is to predetermine the amount of compensation due for damages, freeing the beneficiary from the burden of proof in relation to the suffered damages. Therefore, the letter of the provision seems to delete this benefit, excluding that the creditor may claim damages, since the debtor is exonerated from any liability[17]. Indeed, another crucial feature of

[15] Cass. Civ., section III, (ud. 22-03-2007) 24-07-2007, no. 16315.
[16] Cass. Civ.; 1988 n. 1417; Cass. Civ.; 1990 n. 2803.
[17] Trib. Roma; sez. XVII, 24/02/2020, n. 4018 *"... the function of a penal clause is to predetermine the amount of compensation for the damage, freeing the beneficiary from the burden of proof regarding the damage itself. If it must be recognised that the real advantage of the criminal clause does not lie in the predetermination of the compensation, but rather in the exemption from the proof of having suffered such an amount of damage, it is also true that this exemption is the very essence of the criminal clause, which according to the Civil Code is not in itself unfair, except when the limit of excessive and manifest onerousness for the weaker party is exceeded; which brings the problem strictly back to the*

the penalty clause is its connection with the culpable non-performance of one of the parties, reason why it cannot be configured when it is linked to the occurrence of a fortuitous event or, in any case, not attributable to the party[18].

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D. RENEGOTIATION OF EXISTING CONTRACTS

As mentioned in the above introduction, the ongoing health emergency and the containment measures are having a detrimental effect on the whole economy thus leading to the assessment of the opportunity of renegotiating existing contracts. The instrument of termination, in fact – however useful it may be – producing an *ex tunc* effect of termination of the contractual bond, does not always appear to be the most suitable means to protect the interests of the parties. For this reason, it does not seem to be able to fully satisfy the coexistence of an interest in the continuation - post-emergency - of the relationship and an interest in mitigating the impact of *force majeure*. In particular, the resolution appears to be an excessive remedy capable of negatively affecting the economic recovery of the country.

With regard to the renegotiation of contractual terms and conditions, it is not uncommon for the parties, in the exercise of their contractual autonomy, to have specifically agreed on the obligation to renegotiate when predetermined circumstances occur, in which case reference should be made to them.

What occurs when the Parties have not agreed anything in this regard?

The ICC does not provide for a general obligation to renegotiate the contract, not even in the case under discussion. However, some of the institutions regulated by the civil code assume a similar obligation and we must refer to them. Among the rules of the ICC referred to the renegotiation of the contract, Article 1467 of the Italian Civil Code in contracts with continuous or deferred performances, allows the non-defaulting party at the occurrence of "extraordinary and unforeseeable events" to offer the injured party the alternative between termination and renegotiation of the contractual conditions, as a physiological alternative to avoid termination. This provision, in compliance with the *rebus sic stantibus* principle and the principle of good faith in the execution of the contract pursuant to articles 1374 and 1375 of the ICC, provides an instrument - alternative to termination - to remedy unforeseen changes in the contractual conditions.

This is not all. Art. 1450 of the ICC, in the context of the rules governing the rescission of the contract states that, the contracting party against whom the termination of the contract is requested can avoid it by offering the damaged party to restore the economic value of the performance to a fair relationship.

In addition to the before mentioned assumptions, the following provisions must be noted:

economic evaluation of the quantum of the penalty, the amount of which, in this case, being minimal in relation to the main obligation, cannot ontologically be considered "manifestly excessive"...".

[18] Trib. Napoli; sec. IX , 02/10/2019, n. 8673.

- Article 1623 of the ICC, which regulates rent and lease, provides that "... *If, as a result of a provision of law, a corporate law or a measure of the authorities concerning the management of production,* (factum principis) *the contractual relationship is significantly modified so that the parties suffer a loss and an advantage respectively, it may be required an increase or decrease in rent or, depending on the circumstances, the termination of the contract. This is without prejudice to the different provisions of the law, the corporate law or the measure of the authority*";

- Article 1664 of the ICC dealing with procurements, provides for: (*i*) the possibility of reviewing the contract price where it is modified due to unforeseeable circumstances which have increased or decreased the price of materials and/or labour; (*ii*) fair compensation when, during the course of the work, difficulties in performance arise due to geological, water and similar causes, not foreseen by the parties, which render the contractor's performance considerably more onerous.

This brief examination suggests that the legislator, although it did not provide for a generic obligation to renegotiate, has nevertheless shown a strong *favor* towards the preservation of the contractual obligation, considered the risks associated with unforeseen and unforeseeable extraordinary events.

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E. CONCLUSIONS

In the light of the above, it is deemed possible, at the occurrence of the events under discussion (or similar), to start a renegotiation of the pending contract with the counterparty, even whether the contract does not expressly provide for, basing the need for renegotiation on the willingness to preserve the contract, although impacted by the event of *force majeure*, under different conditions.

With regard to rent and lease agreement, the renegotiation may not be limited to the emergency period, but may be more structural thus aligning the growth of the payments with the contemporary recovery in revenues using a clause of substantial indexation to turnover.

The issue of *force majeure*, then, can be used to interrupt and/or renegotiate the main contracts for the supply of goods and the procurement of services, taking into account the obligation to notify the impossibility occurred due to *force majeure*, under the penalty of the counterparty's right to claim damages.

Indeed, although the emergency legislation has not explicitly provided for such an obligation to notify the counterparty, it is true that it has not even expressly exempted the debtor from it, which is why it is considered that the general principles laid down in the matter should be respected.

Additionally, the Ministry of Economic Development has made it known that the Chambers of Commerce can issue declarations on the state of emergency following the COVID-19 epidemic and on the restrictions imposed by the law to contain the epidemic, with reference to contracts with foreign counterparties. This is due to the fact that many contracts stipulated with foreign counterparties require the production of certifications attesting the impossibility to fulfil the performance in the event of *force majeure*.

Confindustria (General Confederation of Italian Industry) is currently working on the issuance of these certifications, also with regard to domestic contracts.

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