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COVID-19
Effects on Supply Chains

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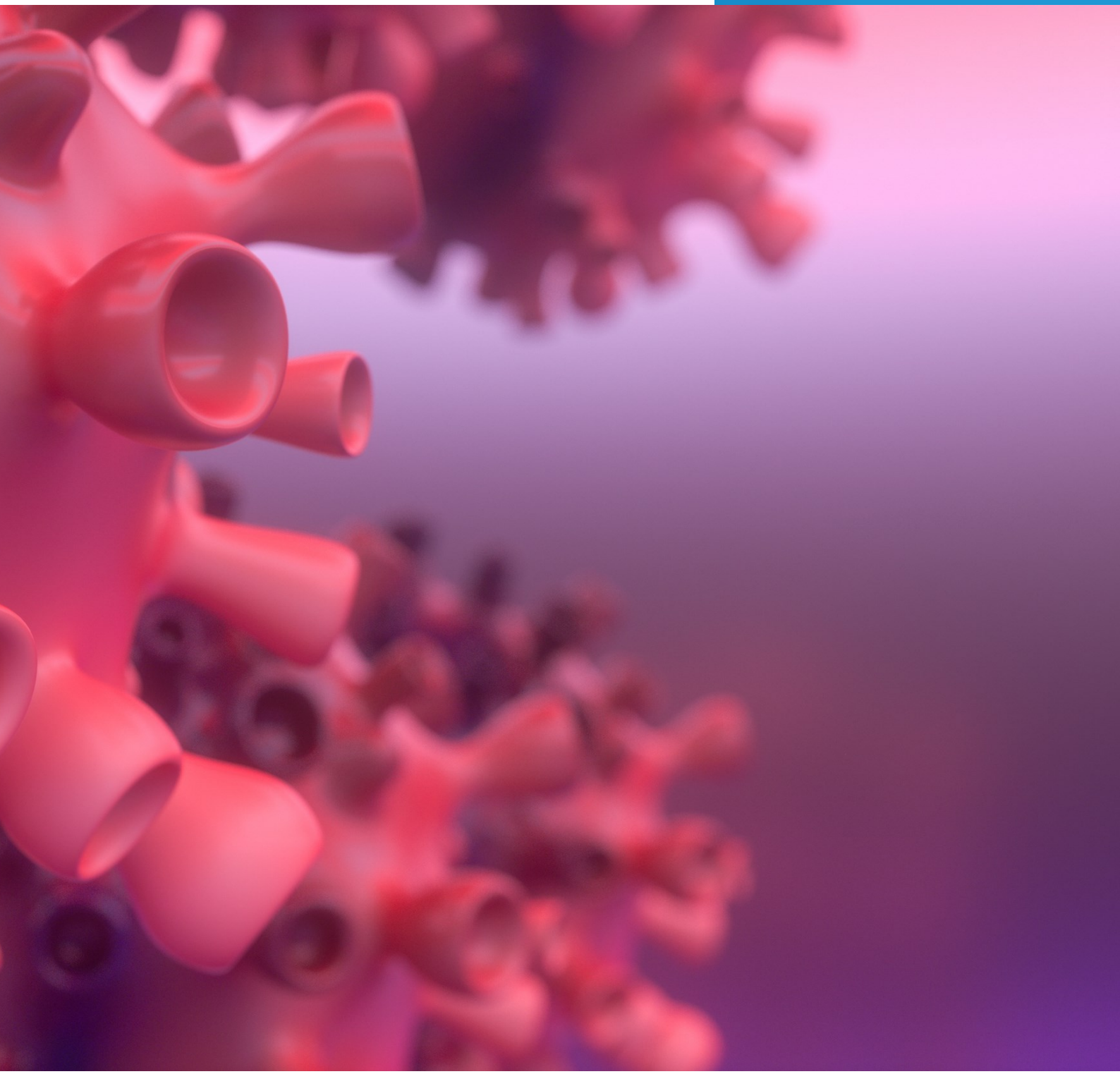

Effects of COVID-19 on Supply Chains and Production Relationships

Introduction

Initially, the focus of the global spread of coronavirus was on the health implications. On 11 February 2020, the virus was officially named "COVID-19". Almost 175,000 people worldwide have been infected by COVID-19 and, as of 16 March 2020, around 6,700 of those infections have been fatal. In addition to the health implications, coronavirus has affected the entire global economy and German companies are becoming increasingly aware of the legal issues associated with the virus. On 30 January 2020, the World Health Organisation (WHO) declared the situation an international health emergency and the economic situation continues to decline. On 3 February 2020, the Foreign Office of the Federal Republic of Germany issued a travel warning for the Chinese province of Hubei, which added to the situation, as did the introduction of travel restrictions and quarantine measures by a number of other countries. Such restrictions are increasing daily. On 11 March 2020, the Director-General of WHO finally declared the infection a pandemic.

Many companies that operate internationally have already felt the effects of the initial Chinese quarantine measures. A large number of them have relocated their headquarters or production sites. The burdensome restrictions on public life have meant that a vast number of the population are unable to carry out their daily work and productivity has slowed and/or halted as a result. Similar measures have since been imposed in Europe and employees are no longer able to travel to work every day, due to government advice and because school and day-care closures have meant parents with childcare responsibilities must stay at home to look after their families.

More and more companies in Germany are having to close down sites or cease production. This ultimately leads to pandemic-related supply bottlenecks and downtime for many companies. In addition to travel and labour-related legal consequences, the main concern for companies producing in China and other severely affected areas is the effect on their supply and production relationships. This is where "force majeure" clauses can play a central role.

What does force majeure mean?

In legal terms, "force majeure", also known as "Acts of God", is defined by the German courts as:

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> "An external event, caused externally, by elementary natural forces or by the actions of third parties, which is unforeseeable according to human insight and experience, cannot be prevented or rendered harmless by economically-accepted means, even by the utmost care that could be reasonably expected in the circumstances, and which is not to be accepted by the operating company due to its frequency. Examples include war, terrorist attacks or natural disasters."

A force majeure clause aims to regulate the consequences of such events for the supply relationship. It outlines which obligations have to be fulfilled, the necessary notification provisions and any rights of termination. In many cases, the party affected by the event is released from its obligations to perform under the contract. At the same time, any rights of the other party to receive compensation will be excluded. The drafting of a force majeure clause will differ between individual contracts and the provisions must be analysed for each individual case.

COVID-19 as force majeure?

For the COVID-19 pandemic to constitute a force majeure, it is crucial for the contract to specify this within the force majeure clause. If the contract does not contain a provision to this effect, parties must rely upon the law of the country where the contract was made.

Contractual regulation on force majeure

For a force majeure clause to be valid, the "COVID-19 crisis" should be included in it. German law does not recognise the term force majeure. Instead, the above definition developed by the German courts can serve as a yardstick for the classification of an event as a force majeure. This approach will only succeed if the affected party who wishes to invoke the clause can prove the requisite factors to the court. In the case of a pandemic, the characteristics of an external non-operational event should be easy to prove. However, the unpredictability of the ongoing event will be more difficult to prove given the current developments in other countries. Furthermore, the event and its consequences must not be "preventable or rendered harmless by economically-accepted means, even by the utmost care that could be reasonably expected in the circumstances". The affected party must therefore prove that the need for alternative sourcing of goods or services was not foreseeable and cannot be carried out at present. Only once the requisite factors have been successfully proved can a force majeure clause be relied upon and enforced.

Contracts without a force majeure clause

If the contract does not contain a force majeure clause, individuals must rely on the law of the country where the contract was made.

Legal provision in UN sales law

The United Nations Convention on Contracts for the International Sale of Goods (CISG), which can be applied to international contracts for the sale of goods unless expressly waived by the parties, contains a force majeure provision in Article 79. It expressly provides for the exemption of the obligation to pay damages and excludes the supplier's liability in cases where the inability to perform contractual obligations results from a force majeure. The burden of proof is on the party failing to fulfil its contractual obligations to show that non-fulfilment is due to an obstacle beyond its control. In contrast to the German Civil Code (BGB), the UN CISG thus excludes the liability of the seller, irrespective of fault. It is generally accepted that, in addition to the expressly-regulated exemption from liability for damages, the obligation to fulfil the contract also ceases to apply if fulfilment would, objectively, be impossible.

However, Article 79 does not completely exclude the obligation to avoid the obstacle to performance or to bear additional expense. For example, alternative means of transport may involve significant financial loss for the supplier but may be considered reasonable in the circumstances.

Legal provision in German law

If a supply contract without a force majeure clause is subject to German law, the general legal provisions under German law will apply. Pursuant to these, cases of force majeure are treated under the rules of impossibility under section 275 BGB, or the loss of the basis of the business under section 313 BGB.

Section 275 BGB excludes a claim for performance in a case where performance is impossible for the debtor, or anyone else. The debtor may also refuse performance if it would involve unreasonable expense. In these cases, the creditor's obligation to provide consideration (i.e. pay-

ment obligation) does not apply according to section 326 BGB.

The decisive factor for claims for damages is whether the debtor has caused the obstacle to performance culpably. A fault-based liability will apply here, by which fault is presumed and the burden of proof is on the debtor to show he is not at fault. The supplier must also prove, as is the case when relying on a force majeure clause, that performance is impossible and that the force majeure event could not have been avoided by purchasing from an alternative source.

Section 275 BGB may be relied upon, for example, where a supplier can prove that his production facility was closed down due to an official order. If the impossibility is only temporary and performance can also be provided at a later date, the debtor is only released from the obligation to perform for the duration of the impediment of performance; the same applies to the creditor's obligation to pay. However, it is then usually possible to withdraw from the contract (according to section 323 BGB).

In general, the customer shall not be entitled to claim damages, but only under special circumstances, for example if the production facilities have been closed on a voluntary basis purely as a precautionary measure (without a corresponding official order). In this case, the supplier would need to prove that the closure was necessary. If such proof fails, the supplier's creditors may, if applicable, issue a claim for damages under sections 280 et seq. BGB on the grounds of failure to perform or delay in performance. The damages include, but are not limited to, costs for additional purchases from an alternative supplier and marketing, such as printing costs for updating flyers. They may also include loss of profit.

Alternatively, section 313 BGB allows for an adjustment of the contract if there has been a material change in the circumstances upon which the contract was based. However, the prerequisite for this is that the obligated party can no longer be reasonably expected to adhere to the contract and that the circumstances were not foreseeable at the time the contract was concluded. If an adjustment of the contract is not possible or cannot reasonably be expected, the contract can be terminated. However, the bar is high with regards to the requirements that must be satisfied. Section 313 BGB may be applicable if production materials are still available due to an unforeseeable event, the risk of which neither of the parties should have to bear, but are significantly scarce and more expensive. The distinction between impossibility and the ceasing to exit of the basis of the transaction is difficult in individual cases, but mostly not relevant in view of the ultimate legal consequence (withdrawal/contract termination).

Temporary special arrangement for micro -enterprises

As part of a COVID package of measures, the German Bundestag adopted temporary regulations on 25 March 2020, which allow debtors who are unable to fulfil their contractual obligations due to the COVID-19 pandemic to temporarily refuse or discontinue performance without incurring adverse legal consequences for them. For many contractual obligations, a right to refuse performance is established for consumers and micro-enterprises (enterprises with up to 10 employees and an annual turnover not exceeding EUR 2 million) until 30 June 2020, which are currently unable to meet their obligations arising from contracts which contain material continuing commitments and were concluded before 8 March 2020 due to the consequences of the COVID-19 pandemic. The right to refuse performance is excluded if its assertion is unreasonable for the creditor. In this case, the debtor has a right of termination.

Conclusion

Affected companies should contact their counterparties as early as possible (and formally on record) to inform them of any bottlenecks caused by the pandemic and, if necessary, to clarify the procedure going forward. In particular, alternative measures should be considered, taking into account what is reasonable for the supplier.

The contractual provisions should be analysed and interpreted in order to determine which law applies to the contract, whether there are any potential claims and, in the event that a force majeure clause is contained within the contract, whether the COVID-19 pandemic falls under that clause.

It should be emphasised that each case must be considered individually and, as such, there is no general principle that will apply in all cases.

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