LEGAL INSIGHTS OF NOBOA, PEÑA & TORRES, ABOGADOS

THE SITUATION OF CONTRACTS FACING THE EFFECTS OF COVID-19

NOBOA, PEÑA & TORRES

ABOGADOS ECUADOR

WWW.LEGALECUADOR.COM

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ABSTRACT: Notwithstanding that contracts are laws for the contracting parties, circumstances beyond their control may occur preventing or complicating their compliance. Taking into consideration the crisis that we are currently experiencing because of the COVID-19, in this essay we will summarize some of them: 1. Force majeure or fortuitous case. 2. Pacta sunt servanda and the consequences of rebus sic stantibus. 3. The Theory of Unpredictability. 4. The rupture of the economic equilibrium of contracts. 5. Clauses of adverse material effect. 6. The impossibility of performance. 7. Possibility of preventive tenders 8. Judicial or arbitral enforceability of contracts in these times.

One of the biggest concerns generated as a consequence of the unfortunate COVID-19 worldwide pandemic is the effects that said event have caused and will probably continue to cause in the future, regarding resolutions and measures adopted by each country, in our case, Ecuador. These effects are severely influenced by certain legal notions that become increasingly important and probably motivate certain conversations or approaches among entrepreneurs and economic operators, which will be briefly referred to below.

Before talking about these notions, it must be clear that in business sector, there are different types of contracts that generate different effects; thus, there are lease of facilities and equipment contracts; there are supply contracts; contracts of distribution of products of different nature; provision of services contracts; joint ventures and other

types of associations, as well as labor contracts, various derived from public contracting, and a great etcetera.

As a principle, all these contracts are law for the parties. This means that first of all, and above all, they have a duty to attempt contractual compliance. But, an extraordinary circumstance such as the one being experienced, means that economic agents, directly and currently (probably the majority) have had to suspend their work and operations in a factual manner, with the consequent effect of losing or seeing substantially reduced its source of income, which causes an immediate cash problem and a potential structural solvency problem; others may continue to operate, but in circumstances complicated by the situation; and in general, many, particularly those within areas sensitive to new social behaviors that are suggested, consider future scenarios with well-founded uncertainties, and all of them analyze, or should analyze, what role or behavior corresponds within the framework of their contracts. And so, in some cases, they will see with concern, that they will not be able to collect their debts or fulfill their own in a timely manner, which could allude to a simple delay, some will be forced to receive restructuring proposals, or even more serious, a simple impossibility to fulfill payment.

Currently, the first effects are being seen in the labor area; but it is likely that these effects will begin to be observed with a certain immediacy in other contractual areas, being the most likely to appear in those related to rental contracts for residences or commercial premises; then those related to supplies, with the waterfall effect that this causes, because if, for example, an agent does not receive the supply of raw materials in a timely manner, the possibility to fulfill their commitments will decrease; others may be affected by the aforementioned social adjustments derived from the crisis, and others by underlying structural effects that it may cause.

As we know contracts are law for contractors, but sometimes circumstances beyond the control of the parties that prevent their fulfillment, or that make it excessively onerous, change the scenario that the parties had at the time the contract was celebrated. This is referred to by the different topics that we will discuss later.

In principle, the various situations must be attended by the contracting parties; others may be influenced or resolved (through regulations) by the state entities as it is al-

ready happening and will probably continue to happen, as in the case of the Board of Monetary and Financial Regulation Policy regarding institutions of the financial sector, or those of a labor nature. It will be necessary to analyze what is regulated in each case.

That said, we will proceed to see what are the legal circumstances that will be discussed by businessmen and their advisers:

1. Force majeure or fortuitous event.

This is defined by Article 30 of the Ecuadorian Civil Code stating that it is the unforeseen event that is impossible to resist. That is to say, it is a situation that, within reason, has not been possible to foresee with a certain advance, which in addition, is irresistible, which means that falls outside the framework of normal (not extraordinary) possibilities that an economic agent or businessman can undertake.

The COVID-19 and the Decree of Exception, which in this case constitutes an act of authority, is an unforeseen event and has been irresistible for the vast majority of companies; therefore, many try to classify it as a force majeure or fortuitous event.

Beyond the digressions regarding the differences between force majeure or fortuitous event (which academically exist), as well as the analysis of expressions that our law uses such that force majeure or fortuitous event was not caused by the fault of an agent , the effect of these events impact contracts, and it does so in different ways depending on the nature of each contract - expressed in very broad terms - as well as the execution times of the obligations they contain. In such a way that, if a contract refers to the delivery of a certain specific good and this is destroyed by the event of force majeure, the loss of that good is suffered by either the creditor or the debtor, depending on certain circumstances, and could result in the termination of the contract; or if the event only decreases or diminishes the thing subject to the obligagation in which case, the contract may not be terminated, but is fulfilled by delivering the thing in the state in which it is found; or if by its nature, the contract is one of those that can continue to be performed once the event in question has been overcome and taking into account, whether it can be considered as a force majeure.

The type of obligation implicit in the contracts is also taken into account, that is if it is a current one, or a deferred one in time (those that are called successive tracts), or if it is an obligation that offers a concrete result, or it is one of means (in which it is o-

ffered to put everything that is, reasonably, within the possibilities of the one who is forced).

In general, the fortuitous event or force majeure pose the analysis of what should be the legal solution that the event has on the contract; this is, if it causes it to be finished, or if it simply must be suspended or deferred over time. Both are effects extremely delicate and important.

Force majeure or fortuitous cases, which are expressly contemplated in the law, are part of our legal tradition, and the Court has referred to this phenomenon on many occasions. As things are in law, its application will depend on the circumstances of each contract.

2. The pacta sunt servanda and the consequences of rebus sic stantibus.

The first of the two terms referred to above, written in Latin, means that the contract is law for the parties and cannot be invalidated except for legal reasons; and the second, that the contracts "are as they are" at the time of contracting, that is to say that, when contracting, the parties have referred to the existing circumstances at that time and have thought that those circumstances, and not others, are those that will regulate the execution of the contract. But the same theory implies the possibility that, if such circumstances change over time, contractual obligations could be altered. We may complement this idea with the fact that contracts carry tacitly a “commutativity", enclosing a balanced interest to the parties; but this balance can be altered by unforeseen circumstances, and in some legislations, this is resorted to in search of a readjustment.

In Ecuador there is no express declaration in the law of what are the practical effects of the rebus sic stantibus principle, but there are jurisprudential rulings that refer to it, opening the possibility of proposing adjustments to the contractual terms.

The legal doctrine, which has been invoked by the Ecuadorian Court, has indicated that within this category, situations such as those of serious uncertainty regarding consideration, impossibility regarding the exercise of the right and, finally, cases of overwhelming provision, can be grouped. That is to say, those benefits that, although possible by themselves, would be to go against the bona fide to demand them, imposing on the debtor an exorbitant sacrifice. That is, there are vestiges - to call them somehow to the traces of recognition - of the invocation of the principle that we re-

view here.

There is little precedent in our country on this matter, so it will be necessary to be attentive to resolutions that are adopted, and in particular, to the circumstances of each contract, to see the procedure of this argument and the approach that is made.

3. The theory of unpredictability.

Although the law recognizes force majeure or fortuitous event with a power capable of extinguishing the obligation or suspending its effects, a theory was also developed for those cases in which, despite being an unforeseen situation, there is no absolute impossibility to comply, but it turns out that compliance becomes excessively onerous given the new circumstances; that is, these unforeseeable circumstances cause the balance of the contract to be broken. This theory, in fact, arises as a consequence of the very serious economic effects of adverse macroeconomic situations, such as hyperinflation.

It is argued that in the event of these unforeseen events, the parties may attempt, as in the previous case, the readjustment of the terms of the contract in the search for more appropriate conditions, and even the termination thereof, requiring for the invocation of this doctrine, that it is not an instant execution contract, that the unforeeseen act is supervening, and that the execution involves an outlay that, given the circumstances, is exaggerated.

Ultimately, the Theory of Unpredictability, as some of the Ecuadorian Court's rulings have said, "is the result of a tacit clause inherent in any long-term contract: the well-known rebus sic stantibus clause ...".

As in the previous case in which there is no express rule on the matter, there is also little Ecuadorian jurisprudence on this matter, and it will be necessary to be vigilant, according to the circumstances of each contract, to see the procedure of this argument and the approach to be made.

4. The breaking of the economic balance of contracts.

In the field of administrative law, the theory of the breaking of the economic balance of contracts has prospered as a cause of eventual readjustments. This is a derivation, from the dogmatic point of view, of the two theories previously indicated.

Indeed, like all contracts, those in the administrative field must be agreed in such a way that there is an economic balance bet-

ween the obligations of the parties, for this reason they are synalagmatic or commutative contracts. Normally, in these contracts, this balance corresponds or is reflected in a financial equation that establishes the time of the conclusion of the same. This balance can be broken either because there is a real, serious and significant effect; and, in this case of COVID-19, we are interested in pointing out that someone could raise it as a strange or external factor that meets these characteristics and that arise unexpectedly and irresistibly (that is, with the attributes of force majeure) and which may be complicating the timely fulfillment of the obligation. We do not know yet if this event will increase the cost of enforcing contracts by having to implement new security measures or for health or environmental measures, but we have to be aware if this happens.

In these cases, the possibility of alleging this breach of the contractual balance that the Ecuadorian Court has considered as a general notion, could be reviewed.

5. Clauses with adverse material effect.

Particularly when dealing with more sophisticated and long-term contracts, especially when parties from different countries intervene, clauses are usually incorporated regarding what are called, adverse material effects; understood these as events that can happen. Usually the parties try to establish what those effects are, in order to avoid future discrepancies; so, if it had been established, in theory, that the impacts of COVID-19 were not part of the pact (and hardly would have been, because there was no news of it until the end of 2019), this clause would not be applicable. But we must be careful, because although COVID-19 was not invoked as a material base cause, they could have alluded to factual circumstances derived from it and find in them, the application of the clause.

A problem would be represented by the existence of a clause of this type that does not describe specific situations, but has been agreed in generic terms, and based on this, it is maintained that COVID-19 situation is included within it. agreed in generic terms, and based on this, it is maintained that COVID-19 situation is included within it. We consider that, in these cases, not being this one of the clauses of adverse effects a regime legislated in the country but submitted to the agreement of the parties, it should be subjected to the rules of interpretation of the clauses of the contracts. It should not be ruled out that our country has more academic and practical experience with the

notion of force majeure or fortuitous event, and that a situation like this, can be channeled as such.

In any case, normally the material adverse effects that are agreed are of a different nature to the force majeure or fortuitous event, and since there is no rule in our country that regulates them, they are subject to the interpretation that can be made of the contract itself by part of the interveners, and at the end, of the judges or arbitrators.

6. The impossibility of compliance.

This is a legal phenomenon that, in our legal doctrine, is more associated with the effect of the loss of the thing that is owned. The legal hypothesis refers to the loss of identifiable and individualizable material goods (certain bodies), but it gives us the impression, in a first approximation, that it is not intimately related to the problem of COVID-19.

This theory does not apply in obligations of generic goods, for that principle that gender does not perish. However, it is important to note that there are certain analogies that can be made in the world of law, and that legal doctrines have made the analysis of the impossibility regarding the obligations to do; at this point, these will be affected either with the termination of the contract, if the obligation - given the nature of the commitment itself - cannot be made and that impossibility derives from the fortuitous case, or if it is simply deferrable, in which case it would simply be in default during the fortuitous event, and the provision applicable to the matter indicates that the damages derived from the delay resulting from the force majeure or fortuitous event are not due. The analysis can also be done from the perspective of the obligations “not to do” (that is, those that entail abstentions), and should be based on the nature of the contracted obligation.

7. Possibilities of preventive contests.

There is the possibility that a debtor (company) indicates that his circumstances are within the context of articles 1 and 4 of the Preventive Bankruptcy Law, the latter which includes in literal a) “Non-compliancefor more than sixty days of one or more mercantile obligations and that represent in total thirty percent or more of the value of the total liability ", or in its literal e) "When the losses reach fifty percent or more of the share capital and all of its reserves".

We will have to be vigilant to see if the circumstances have really occurred, and

what alternatives are possible when invoking the provenance of this contest. In particular, we cannot ignore the fact that this type of bankruptcy proceeds both, at the request of the debtor and the creditors.

8. Judicial or arbitration enforceability of contracts in these times.

The possibility of judicial enforceability of contractual commitments does not cease to exist, but it will probably be influenced by the arguments that the counterparty will make invoking some of the aforementioned situations.

Conclusion

Having said all of the above, there are no written guidelines applicable to all contracts. Each contract must be analyzed taking into account its circumstances and terms, and even its future possibilities, which is an issue of great importance, particularly for long-term contracts that will be severely affected, as we said at the beginning, by the effects of the COVID-19 and the regulations issued in this regard; all this so that, invoking the theories and principles outlined, must first be selective and properly analyzed case by case, considering that when facing the various situations or arguments, the position submitted to the analysis must be taken into account, being the principles to follow:

(1) That in general terms the contracts must be fulfilled in the agreed terms;

(2) That force majeure or fortuitous event may not be the source of termination of all contracts but of deferment without entailing the payment of damages;

(3) That the other theories and principles mentioned in this document are, also, of responsible use and analysis; and,

(4) That each contract, and the future of relationships, should be subject to timely scrutiny to see if there is full enforceability, or if there are sensitive renegotiations that try to get the parties to obtain mutually winning positions.

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NOBOA, PEÑA & TORRES
ABOGADOS ECUADOR

DR. GONZALO NOBOA BAQUERIZO

Principal Author

ABG. MARGARITA VELEZ

Co-author