DISPUTE RESOLUTION

CLIENT ALERT

MARCH/2020

THE COVID-19 PANDEMIC AND TAKE-OR-PAY CLAUSES

The take-or-pay (or ship-or-pay) clause has its own characteristics related to the distribution of contract risks between the parties and, for this reason, the impact of the COVID-19 pandemic on such provisions must be carefully analyzed.

The dispersion of COVID-19 and the measures suggested by epidemiologists to try to contain it have led governments to enact severe measures to restrict the movement of people, goods and services. In Brazil, several states and municipalities have ordered the closure of schools, commerce and a reduction in the attendance of public agencies, among other measures. The federal government also announced actions aimed at minimizing the impacts of the pandemic on the economy, from stimulus packages to economic activity - including the decree of public calamity for the purpose of revising the limits of the Fiscal Responsibility Law - to easing labor rules.

COVID-19 and the measures adopted to contain it shall have an unprecedented impact on economic activity and commercial relations. In particular, there are direct consequences for long-term contracts with clauses such as take-or-pay or ship-or-pay.

Due to the dynamics of these clauses, one of the contractors is obliged to pay for the provision of a minimum and previously stipulated quantity of goods or services, even in the cases in which it does not use them in full. The take-or-pay clause is typical of long-term contracts of gas and oil supply, ore transport, etc.

The rationale for clauses of this nature is precisely the allocation of risks among the contractors, mainly because, commonly, there are large investments related to the fulfillment of the contract. Whereas the service provider and goods seller guarantees the stability of the demand for its service/product, obtaining protection from the risks of it being reduced in the future and, the counterparty rests assured that it will be offered what they need.

It is precisely because its primary objective is to allocate risks that the take-or-pay clause can be the subject of discussions within the scope of the COVID-19 pandemic, since both the disease itself and the measures that have been announced to contain it can mean the materialization of both risks of reduced

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demand and the offer for certain products or services. Initially, it is important to investigate whether the consequences of the pandemic lead to (i) impossibility or (ii) just a difficulty in fulfilling the contract. Depending on the degree of impact on the obligations provided for in the contract, it can be argued either that the agreement is extinguished due to force majeure events or that it needs to be readjusted due to excessive costs.

In the first case, the regulation is in art. 393 of the Brazilian Civil Code, according which "[the] debtor is not liable for damages resulting from unforeseeable circumstances or force majeure, if expressly not responsible for them". Therefore, as a rule, the debtor is exonerated for defaulting on his obligations when this arises from "a necessary fact, the effects of which it was not possible to avoid or prevent" [1].

The contract can also be terminated or revised based on the unpredictability theory (*teoria da imprevisão*), supported by arts. 478 et seq. of the Brazilian Civil Code. In this case, the legislation provides that the obligations agreed by the parties can be revised when there is an extraordinary and unpredictable fact, which generates an excessive burden for one of them and an extreme advantage for the other. It is important to notice that it is the burden of the aggrieved party to demonstrate that there was an effective change in the contractual basis in relation to that at the time the contract was signed.

As the take-or-pay clauses are essentially defined within the scope of the parties' autonomy, the examination of the impacts of the COVID-19 pandemic depends on the analysis of each specific case. In addition, the assessment of the impact of the pandemic on the contract may give rise to relevant discussions on the causal link, especially on whether there is an interruption between the alleged cause of force majeure or excessive burden and the damages claimed. This is especially relevant in cases where there are long supply chains, where each stage can be affected differently by the pandemic.

Without prejudice to this, contracts with these clauses usually contain some standard forecasts with "escape" mechanisms for unpredictable situations. In this sense, it is essential to assess whether the contract includes the so-called hardship clauses, which leads the parties to renegotiate the basis of the contract - such as, for example, the definitions of the minimum values of offer and demand for a given product or service - in case of modification of the conditions originally agreed.

Compensation clauses for deviations from the average use of the service or merchandise throughout the contract, such as make up and carry forward rights, may also play a relevant role. In such cases, the contract already provides for the possibility for one of the parties to offset a use of the volume of goods or services contracted below the forecast with a future surplus, or else to use the past surplus to offset a lesser use at present.

Especially in long-term contracts, linked to high investments by the contracting parties, it is important that they always observe the duty to act in good faith. Under unexpected situations, such as the present pandemic, the parties must adopt a cautious stance and always aim at minimizing their own losses and, when possible, of the counterparty (duty to mitigate the loss), as well as documenting in detail and maintaining the other party informed of the impacts of COVID-19 on the contractual relationship.

Veirano Advogados has multidisciplinary teams prepared to advise clients in the context of the COVID-19 pandemic, with extensive knowledge of contracts with take-or-pay clauses, which require special attention in view of the particularities discussed above. If you have any questions regarding the content from the client alert, do not hesitate to contact us.

[1] TEPEDINO, Gustavo; BARBOZA, Heloisa Helena; MORAES, Maria Celina Bodin de. *Código Civil interpretado conforme a Constituição da República*, v. I, Rio de Janeiro: Renovar, 2007, p. 709.