CLIENT UPDATE

MEXICO EXCUSES FOR NON-PERFORMANCE AND COVID 19: FORCE MAJEURE, MATERIAL ADVERSE CHANGE AND UNILATERALLY-INDUCED CHANGE OF CIRCUMSTANCES

As private industry and government authorities continue to address consequences of COVID-19, market participants are evaluating the implications of the public health crisis for a wide range of contracts. This Client Update provides a summary of three doctrines that, subject to the facts and circumstances, may provide a basis for temporarily or permanently excusing performance of contractual obligations: *force majeure* clauses, material adverse change clauses and unilaterally-induced changes of circumstances to the detritment of a party.

Force Majeure

As a general rule of Mexican law, commercial contracts must be performed, unless the parties have expressly stipulated a *force majeure* clause. As an exception, in a few limited instances, *force majeure* can be invoked in certain contracts without the need for an express stipulation, including rendering of certification services, commissions, deposits, transportation and some instances of consignments.[1]

Force majeure clauses in contracts allocate risk by excusing one party's nonperformance when its performance has been made impossible due to circumstances beyond its control. The applicability of a force majeure provision to a particular set of facts will depend in large part on specific contract language, which may relax or tighten the elements of establishing a *force majeure* and may impose specific notice requirements. Such contract language must be clearly articulated. The law in this area will be confronted by current events and will likely develop quickly in the face of the COVID-19 pandemia.

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[1] Commercial Code (*Código de Comercio*), arts. 95 bis 5, 295, 336, 393 and 579; Civil Code for the Federal District (*Código Civil para el Distrito Federal*), arts. 1796 and 1797.

In civil contracts (fundamentally, non-commercial contracts), *force majeure* is an excuse for non-performance by operation of law, unless it has been expressly waived by the parties or there has been a contributory conduct by the party alleging it. Mexican courts have found that the main requirements of *force majeure* as a valid excuse for non-performance in civil contracts are (i) an external event or action, (ii) unsurmountable, (iii) unforeseen at the time the contract was made.[2]

In both commercial and civil contracts, when performance is excused due to *force majeure*, it may be excused only for the period during which such conditions persist and prevent performance. When a *force majeure* event ends, the parties' obligations to perform could be promptly reinstated.

Material Adverse Change

The impact the COVID-19 outbreak has had on particular industries, industry sectors, and the entire economy, compounded by uncertainty about the duration and magnitude of its effects, presents a difficult challenge for parties negotiating M&A agreements under these circumstances.

A material adverse change (MAC) must be expressly and clearly stipulated, so as to be given effect in a M&A agreement. Sellers normally propose that the buyer bears all risk associated with COVID-19 since the principal risk is known. The seller of a company today, is likely accepting a lower price than might have been obtained just a few weeks ago, so it does not want to give the buyer a further recourse relating to this matter. On the other hand, a buyer is unable to evaluate the full extent of the risk that COVID-19 represents, and the buyer might reasonably want to be able to walk away if things get a lot worse or affect a particular business in a way that might not be reasonably anticipated at the time of signing the transaction.

The most favorable way to allocate this risk from a seller's viewpoint would be to make clear in the acquisition agreement that the buyer is bearing it. Under this structure, COVID-19 as well as responses to the pandemic by the target (and its customers and suppliers), the government and the markets generally, could be expressly excluded from the material adverse change definition and from the obligation to operate the target business in the ordinary course of business between signing and closing.

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[2] Civil Code for the Federal District (*Código Civil para el Distrito Federal*, arts. 1847 and 2111). Novena Época, Registro 173722, Tribunales Colegiados de Circuito, Tesis Aislada, Semanario Judicial de la Federación y su Gaceta, Tomo XXIV, Diciembre de 2006, Materia Civil, Tesis 1.3º.C.567 C, pág. 1378.

An alternative structure might be to exclude COVID-19 and like events from the MAC definition and ordinary course covenant, but to define those events such that the exclusion does not cover a material worsening of the effects of the event (or possibly a material worsening that has a disproportionate impact on the target). A potential for dispute must be anticipated by the parties; this being a frequent feature of the MAC clause, which seldom if ever, defines materiality on specific terms.

Another possible alternative would be to combine one of the structures summarized above with a break-up fee payable by the buyer if it fails to close for COVID-19-related reasons. This may partially compensate the seller if the impact of COVID-19 on the target proves too great for the buyer. It may also persuade the buyer not to walk away from the deal, unless the situation is seriously deteriorating.

A range of variations on the above alternatives may be devised.

Unilaterally-induced Change of Circumstances

Under a separate but related theory, Mexican law provides that the content of an obligation cannot be left to the will of one of the contracting parties. Based upon such provision, unreasonable changes made by a governmental entity to the basis under which an investor was invited to enter into a contract, may provide a basis to either excuse such investor from performing under the contract, consequently dispensing payment of penalties, or enable the filing of a claim for damages against such governmental entity.[3]

International arbitration tribunals have found in a number of cases that there are treaty provisions that seek the protection of an investor's legitimate expectations and that the right of a governmental entity to introduce a regulatory change that affects such expectations is not unrestrained.

The scope of "legitimate expectations" will vary according to the investment treaty framework, the legal framework in place in the host country and the specific facts of the case.

Tribunals have found that there are certain instances where there is a specific framework for energy-focused investments that obliges host countries to "afford fundamental stability in the essential characteristics of the legal regime relied upon by the investors in making long-term investments." This means countries cannot suddenly and radically alter the regulatory

[3] Civil Code for the Federal District (*Código Civil para el Distrito Federal*), art. 1787. Primer Tribunal Colegiado en Materias Administrativa y del Trabajo del Décimo Primer Circuito. Décima Época, Registro 2016332, Tribunales Colegiados de Circuito, Jurisprudencia, Gaceta del Semanario Judicial de la Federación, Libro 52, Marzo de 2018, Tomo IV, Materia Administrativa, Tesis XI.1o.A.T. J/15 (10a.), pág. 3087.

framework in place at the time of the investment. The content and scope of legitimate investor expectations created by such obligations may differ, however, in cases involving treaties "where no specific obligation of stability is contained."

Some 2019 awards provide guidance as to the scope of treaty protections as the same apply to the protection of legitimate expectations. As a result, investors had a legitimate expectation that the regulatory regime upon which their investments were based would not undergo a total and unreasonable change.[4]

The rationale for such awards would appear to share a basic element with the fundamental rule of Mexican law mentioned before, providing that the content of an obligation cannot be left to the will of one of the contracting parties, the same being in this instance a governmental entity. It would appear thus, that a foreign arbitral award or judgement rendered upon such basis, should be enforceable upon assets of the governmental entity outside of Mexico, or should be recognized and enforced in Mexico, provided it would not violate a public policy provision of Mexican law.

For investors, careful investment structuring considering investment treaty and legitimate expectations protections, offers an additional form of investment securitization.

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We will keep you posted on future developments.

Please do not hesitate to contact us with any questions.

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[4] See: NextEra Energy Global Holdings BV and NextEra Energy Spain Holdings BV v. Kingdom of Spain FET 2013–2014 31 May 2019; 9REN Holding S.à r.l. v. Kingdom of Spain FET 2010–2014 31 May 2019; Cube Infrastructure Fund SICAV and others v. Kingdom of Spain FET 2013–2014 15 July 2019; SolEs Badajoz GmbH v. Kingdom of Spain FET 2013–2014 31 July 2019; InfraRed Environmental Infrastructure GP Limited and others v. Kingdom of Spain [Award not public] 2 August 2019; OperaFund Eco-Invest SICAV PLC and Schwab Holding AG v. Kingdom of Spain FET 2010–2014 6 Sept. 2019.