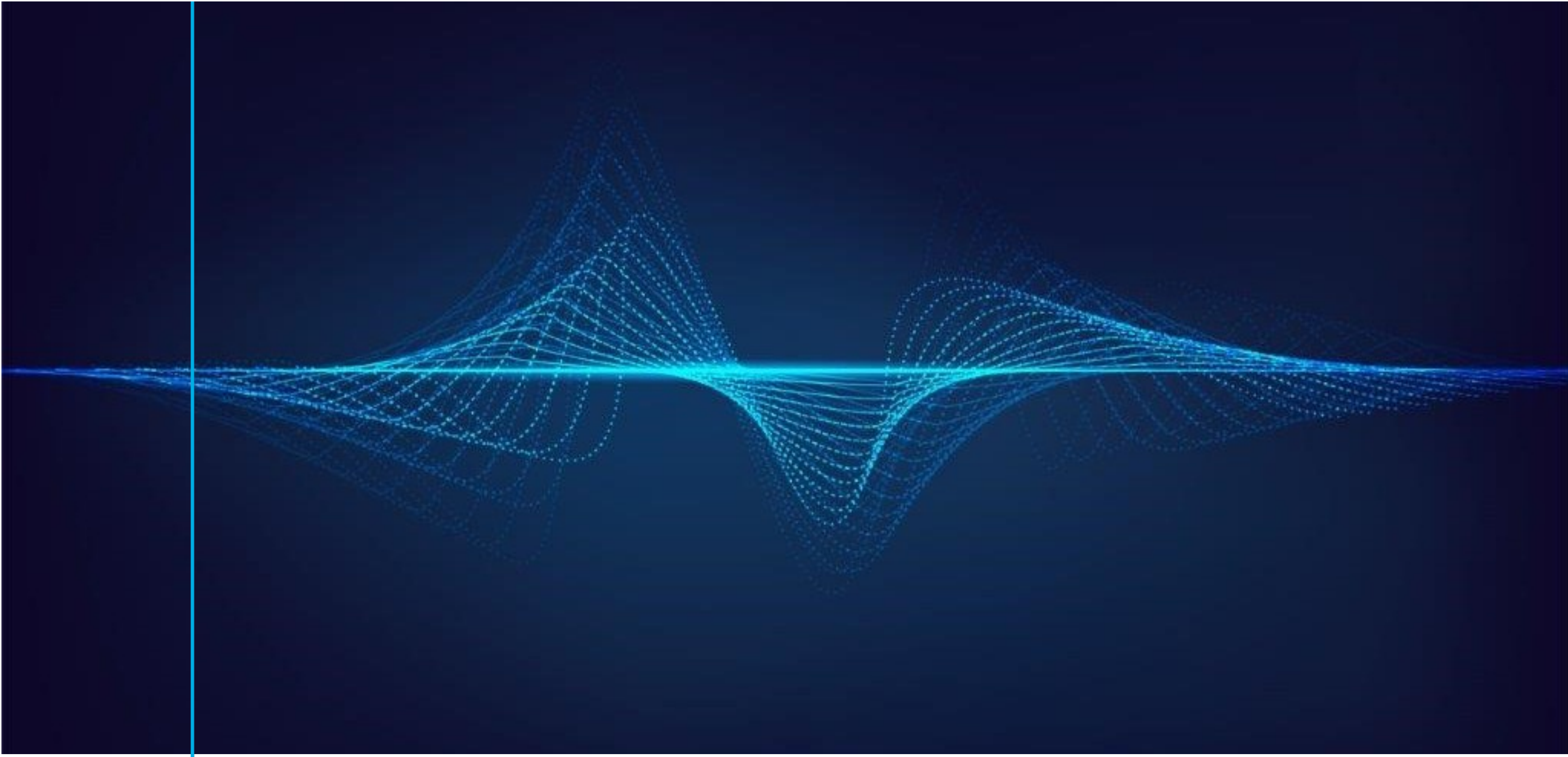

Covid-19: Impact on (the Other) TP

Contemplating Force Majeure and Other Contractual Considerations in Intercompany Agreements

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I. INTRODUCTION

Because of the unprecedented business and economic disruption caused by the Covid-19 pandemic, companies are considering defenses that might excuse non-performance of a contract, such as invoking force majeure clauses, or potentially less drastic options such as renegotiating contractual terms. In some cases, companies have already begun to file suit to invoke force majeure clauses.[1] Below we discuss the transfer pricing implications of companies seeking (or not seeking) to effectively invoke force majeure clauses in intercompany agreements, as well as similar contractual considerations in the absence of a force majeure clause.

II. WHAT IS A FORCE MAJEURE CLAUSE?

The concept of force majeure is widely recognized in both civil law and common law jurisdictions. Force majeure clauses define circumstances beyond the parties' control that can render contractual performance too difficult or even impossible. Where an event, or series of events, triggers a force majeure clause, the party invoking the clause may suspend, defer, or be released from its duties to perform without liability. Force majeure clauses in commercial agreements typically provide a list of specific events outside of the contracting parties' control that, upon occurrence, would excuse or delay the invoking party's performance, or permit the cancellation of the contract (e.g., war, terrorist attacks, famine, earthquakes, floods, strikes, fire, epidemics, acts of God, and government action).

Certain European civil law countries such as Luxembourg, the Netherlands, and Spain, at least implicitly recognize the force majeure principle in their civil codes. Under Dutch and Spanish law, for instance, a force majeure clause does not need to be included in a contract because the statutory force majeure provisions apply automatically to all contracts. This, however, does not preclude parties from incorporating their own specific force majeure clause to deviate from the rules provided by law.

In common law jurisdictions, the application of force majeure is an issue of contract interpretation, the result of which may vary depending on the law of the jurisdiction that governs the agreement. A proper assessment of the impact of the Covid-19 pandemic requires a fact-specific analysis of a company's business and contractual relationships.[2]

III. HOW DO UNRELATED PARTIES APPROACH FORCE MAJEURE (OR UNANTICIPATED) EVENTS?

As in any transfer pricing analysis, the actions of unrelated parties in the face of the pandemic, of course, are central to analyzing arm's-length behavior for related party transactions. In the context of written contractual arrangements, the starting point is analyzing the written terms of the agreement, which will generally be respected for transfer pricing purposes provided they do not lack economic substance.

Assuming a force majeure clause exists and the circumstances are right, a party in an unrelated party context may seek to invoke the clause to avoid the negative implications (or sometimes

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[1] *See e.g., Third Wave Farms LLC v. Pure Valley Solutions LLC*, No. 6:20-cv-00069 (E.D. Ky. Mar. 20, 2020) (Kentucky hemp farming company filed federal suit asking judge to void its contract with an Oregon hemp processor asserting that the spread of the coronavirus and the state of emergency declared in Kentucky and Oregon triggered the contract's force majeure clause).

[2] *See* Jennifer Ancona Semko, Mark Goodman, et al., [*US: When Is Force Majeure Really Force Majeure?*](), Baker McKenzie Insight (Mar.5,2020).

impossibility) of performing its obligations under an agreement, while avoiding the counterparty's ability to obtain specific performance or damages for the party's non-performance. Some common force majeure events in the context of Covid-19 could be natural disasters or governmental prohibition of activities.[3] It is unclear whether a resulting economic crisis may be such an event.[4]

However, given the current uncertainty of the scale of the impact of the pandemic, what magnitude of disruption would qualify as a force majeure event? As in most transfer pricing analyses, the answer depends on the facts and circumstances of the given transaction and business operations at issue. For example, some governmental actions may clearly and legally prohibit certain transactions from occurring in some industries and may be more ambiguous in others. Even if a certain governmental action is clearly within the context of the type of force majeure event contemplated, it may be unclear for companies right now how long they may not be able to perform duties under an agreement.

Further, companies should view the pandemic holistically within the context of the agreement. For example, if an agreement has a 10-year term and the effect of the pandemic prevents a party from performing for only a few months, is that enough to excuse performance? Would the result be different for an agreement with a two-year term? While a subsidiary and parent company would rarely consider the same litigation scenarios between each other as between unrelated parties, such considerations are relevant when considering the uncertainty of a given situation. The practical answer is that unrelated parties will be in court one to two years from now with the benefit of hindsight, but today no one has these answers.

IV. ABSENCE OR INAPPLICABILITY OF FORCE MAJEURE CLAUSES

What if an agreement does not contain a force majeure clause? In the United States, other common law and contractual principles may be available for a company to be excused from contractual obligations due to certain events that may typically be described in force majeure clauses. These include principles such as impossibility, impracticability, frustration of purpose, or the United Nations Convention on Contracts for the International Sale of Goods or Article 2 of the Uniform Commercial Code.[5]

For example, it is against public policy for a company to be compelled to perform a contractual obligation if doing so is against the law. Even if it is legally possible for a company to perform an obligation such as paying rent, perhaps the purpose for which the parties entered into the contract has been frustrated if the party obligated to pay rent cannot legally operate the business for which the parties entered into the contract. Again, the potential applicability of these principles will depend on the facts and circumstances of the given situation. Some of these considerations may be the same or similar as those described above, including duration of excused performance.

Regardless of the presence of a force majeure clause or the applicability of alternative legal remedies mentioned above between related parties, companies may want to consider whether they have the option to revise their intercompany agreements under the assumption that unrelated parties would seek to renegotiate the agreement if unforeseen or unduly burdensome circumstances arise. Under general contractual principles, renegotiating contracts could be viewed as problematic because one party may have a pre-existing duty to perform under the prior contract

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[3] For example, French courts have denied the spread of other illnesses as qualifying force majeure events because they were not considered as unforeseeable or unavoidable. *See, e.g.,* CA Besançon 8-01-2014 no 12/0229 (H1N1); CA Paris 25-9-1998 no 1996/08159 (plague bacile); CA, Paris, 29-06-2006 no 04/09052 (SARS); CA Nancy 22-11-2010 no 09/00003 (dengue fever); CA Basse-Terre 17-12- 2018 no 17/00739 (chikungunya virus).

[4] *See, e.g.,* Luxembourg Court of Appeal on May 8, 2013 (n° 29096) (holding that the economic crisis could not be considered as a force majeure event and could not exempt the debtor of the obligation from reimbursing its loan).

[5] *See* Jennifer Ancona Semko, Mark Goodman, et al., *No Force Majeure Clause? Other Potential Options to Excuse Contractual Performance Under US Law in the Face of Covid-19*, Baker McKenzie Insight (Mar. 6, 2020).

unless consideration is given for terminating the prior contract. However, in actual third-party transactions, parties often do not strictly hold another party to contractual obligations. For example, during Covid-19, there have been several instances of hotels refunding money to businesses for event cancellations and returning deposits in contravention of deposit forfeiture provisions.

When one party is struggling because of unforeseen or extraordinary circumstances, the counterparty may accept alternative performance, e.g., providing a more limited number of components in the short term and then providing an increased supply thereafter until it has fulfilled the backlogged demand. A party may even accept less favorable contractual terms despite a clear contractual right to sue for non-performance. These actions may be undertaken for reasons other than creation or furtherance of goodwill. It may be because it would be more disruptive to find a viable alternative business relationship, or anticipated future business with the counterparty may be more important despite an interruption in the short term. This concept has been accepted by the Tax Court, where renegotiating contracts in the intercompany context was accepted as consistent with the arm's length principle.[6]

It also is possible that having a force majeure clause can be more limiting to related parties than having no such clause. For example, a force majeure clause may not specifically list the event (e.g., an epidemic, pandemic, act of God, or government action), which may leave the non-performing party out of luck or in a court battle over the contract interpretation. The assumption may arise that if only certain events were identified to excuse performance, an event that was not identified was not contemplated to excuse performance.

Accordingly, many intercompany agreements today may not contain a force majeure clause. Regardless, whether or not an intercompany agreement has a force majeure clause, related parties should be free to renegotiate the terms of the agreement depending on the facts and circumstances. The age-old question then arises, are the (re)negotiated terms arm's length?

V. OTHER CONSIDERATIONS BEFORE INVOKING FORCE MAJEURE CLAUSES

Before rushing to seek to terminate and/or renegotiate intercompany agreements for relief of non-performance, it is necessary to consider the economic motivations and business reasons for seeking such relief. For multinational enterprises ("MNEs"), the ripple effect of the business and economic disruption that began in Wuhan, China in December, 2019, and has quickly spread to the rest of the world, may be causing supply chain disruption, worker displacement, business interruption, and depressed profits or losses. While business interruption and supply chain disruption may be clear-cut causes of non-performance, depressed profits or losses are not and, thus, may not be eligible for remedy by invoking a force majeure clause. A contractual obligation to perform is not a guarantee of profits.

If the contractual provisions are satisfied, a force majeure clause may excuse a party for non-performance without compensating the other party. However, that is not always the case. Whether seeking to terminate an agreement by invoking a force majeure clause or otherwise renegotiating it, the resulting economic impact may require indemnification of (compensation for) the harmed party, depending on the circumstances. Chapter IX of the *Organization for Economic Co-Operation and Development (*OECD) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "TPG") deals with the transfer pricing aspects of business restructurings, including the termination or substantial renegotiation of existing arrangements. The TPG recognizes that "business restructurings may be needed to preserve profitability or limit losses, e.g. in the event of an over-capacity situation or in a downturn economy."[7]

[6] *See, e.g., Nestle Co. v. Commissioner,* T.C. Memo 1963-14 (holding that amended licensing agreement between parent and subsidiary was arm's length).
[7] TPG Chapter IX.A.1.

MNEs should evaluate the potential transfer pricing impact of terminating or renegotiating intercompany agreements in the context of the facts, circumstances, functional profiles, division of risks among the parties involved, and whether behavior of the parties and underlying economic substance of the transactions matches the terms of the intercompany agreements.[8] The TPG indicates that, "[t]here should be no presumption that all contract terminations or substantial renegotiations should give a right to indemnification at arm's length, as this will depend on the facts and circumstances of each case." Further, such analysis must also consider the options realistically available to the parties.[9] The TPG recognizes that an entity may agree to a restructuring as a better option than going out of business altogether, e.g., if the restructured entity is actually being saved from the likelihood of a "loss-making opportunity."[10]

Sometimes, rather than terminate or renegotiate agreements, it makes better sense to maintain the current arrangement and deal with the transfer pricing consequences in other ways. For example, if agreements allow for adjustment of transfer prices within a range of arm's-length returns, the low end of the range could be targeted in anticipation of depressed profits.

Documenting and supporting lower returns and losses can be challenging, particularly when using profit-based methods, e.g., the comparable profits method under §482 and the transactional net margin method under the TPG. These methods require comparison of controlled transactions with those of uncontrolled or independent enterprises, as evidenced by the range of net operating profits earned by the independent enterprises. There typically is a delay between when companies file their statutory accounts and when the data becomes available in the databases used for benchmarking analyses. Such delay can make it difficult to support the initial periods of depressed profitability. There are a number of ways to deal with this, including: using only the most recent data (perhaps even quarterly results); revisiting the screening criteria that may have excluded loss- making or financially distressed companies; modifying the multi-year period to capture the full business cycle; and potentially adjusting the results of the comparable companies to account for the economic recession. Perhaps most importantly, analysis of the tested party results should demonstrate, to the extent possible, that the lower profits or losses are not attributable to transfer pricing but rather are attributable to economic circumstances, the risks for which are properly borne by the loss-making party or parties.

VI. CONCLUSION

The Covid-19 pandemic and associated government actions may qualify as a force majeure event, depending on the specific contract language, governing law, and particular facts and circumstances. Many, if not most, intercompany agreements do not contain force majeure clauses, because related parties do not necessarily require all the protective provisions that unrelated parties would insist on in dealing with each other.

In the absence of force majeure clauses in intercompany agreements, related parties can consider alternative legal remedies or renegotiating contracts to deal with non-performance issues or other extraordinary circumstances. Courts have accepted that renegotiating intercompany agreements is consistent with arm's-length dealings. Further, the TPG recognizes that an entity may agree to a restructuring as a better option than going out of business altogether.

Alternatively, MNEs may consider managing the transfer pricing consequences of the Covid-19 pandemic and economic downturn by targeting returns lower in the range of arm's-length benchmarks. Finally, many may consider documenting low profits and losses by demonstrating that such losses are not attributable to transfer pricing but rather are attributable to economic circumstances, the risks for which are properly borne by the loss-making party or parties.

[8] See Reg. § 1.482-1(f)(2)(ii) regarding allocations based on company's actual transactions. All section references herein are to the Internal Revenue Code (the Code), as amended, and to the regulations promulgated thereunder, unless otherwise indicated.
[9] TPG ¶ 9.78.
[10] TPG ¶ 9.71.

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