Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

COVID-19 May Make Incomplete Contracts Renegotiable

By **Robin Hart and Steven Schwartz** (June 23, 2020, 2:21 PM EDT)

Robin Hart

Steven Schwartz

Companies are struggling to adapt to the current economic turbulence created by the COVID-19 pandemic and the governmental responses thereto and, in many cases, contractual relationships may not have fully contemplated these conditions.

Therefore, any current contracts might be argued to be incomplete from an economic perspective, regardless of whether there is a general force majeure clause. The economic study of incomplete contracts provides a principled perspective that is informative for resolving transfer pricing issues that may arise from the pandemic.

The foundational principle of transfer pricing is that intercompany transactions should mimic transactions between independent profit-maximizing companies; and, therefore, intercompany arrangements, in substance or in form, should be subject to the same scrutiny as arrangements between third parties.

The recognition that intercompany agreements may be incomplete provides an economic justification for controlled parties to a transaction to negotiate a temporary or permanent remediation (i.e., an adjustment to the terms of the agreement) to account for unique business impacts, including those due to the global pandemic.

A Primer on Incomplete Contracts

Economists have studied the economics of contracts in a rigorous way for well over 80 years with a particular focus on issues such as the reasons why economic actors enter into contracts; the ways in which those actors interact with one another in bargaining over the scope and comprehensiveness of contract terms; and contractual completeness.

The economic analysis of contracts is distinct from the legal analysis of contracts. Economists focus on, among other things, understanding the behavior of economic actors in the contracting relationship and the economic reasons why certain contractual arrangements emerge and contractual features exist.

An incomplete contract is one in which all the possible outcomes, termed "states of the world," are not considered and not accounted for in the contract.[1] As an economic matter, a contract is incomplete if even one possible outcome in a contract is not considered. According to an article by Oliver Hart and John Moore:

> In an ideal world, the parties would write a contingent contract specifying exactly [what] is to be delivered in each state. However, if the number of states is very large, such a contract would be prohibitively expensive.[2]

In this context, "prohibitively expensive" refers to transaction costs, i.e., time, money or research required to engage in a transaction, whether it be a noncontractual transaction such as purchasing a television or a contractual one such as a supply arrangement between a manufacturer and a raw material provider. All else being equal, the more complex the transaction, the higher the transaction costs.

The basic argument — highly simplified — is that high transaction costs often result in incomplete contracts because it is too expensive — that is, too time-consuming or complex — to write a contract that accounts for every conceivable outcome. It may be that there are too many potential outcomes to possibly account for, that some of the outcomes may not be foreseeable, or that it is too difficult, ex ante, to specify a resolution around certain outcomes.

In such a case, a contract may be entered into that is intended to cover a subset of outcomes that are either likely to occur or where it is possible to resolve that issue at the time the contract is written, potentially via the allocation of certain controllable risks. Other outcomes (e.g., lower or unknown probability of occurrence) are left to negotiation or dispute resolution as and when they arise. Because incomplete contracts can be economically optimal, it may be rational for the parties to agree to incomplete contracts.[3]

What happens when the parties recognize that a contract is incomplete, that is, when they realize that a contingency has developed — such as a pandemic — that was not contemplated in the contract? The rational and economically efficient answer is to have the parties engage in ex post negotiations to devise a contractual approach to dealing with the unanticipated circumstances.[4]

In fact, this ex post renegotiation is the expected response by the parties to the recognition of an incomplete contract.

The prospect of renegotiation — and the terms on which it might take place — may inform the agreement in the first instance; complex issues that may be foreseeable but costly to contract around may be optimally ignored in the contract, with the parties knowing that should that condition arise, the agreement can be recast through further negotiation. However, the ultimate resolution will depend on thenew negotiated agreement.[5]

Application to Transfer Pricing in the Context of Current Economic Conditions

Given the current pandemic, it is easy to imagine disputes on the horizon between transacting parties regarding contracts that are argued to be breached or entirely abrogated, whether because performance is not feasible or because the purpose of the agreement is allegedly frustrated. While many of these contracts may have some form of force majeure clause that may excuse some failures to perform, many will not.

This is likely to also be true in transfer pricing arrangements. As a general matter, intercompany agreements seek to delineate which controlled party to the agreement bears the major risk factors and provides for pricing for the services, goods, intangibles, or financing that targets a range of prices or profitability and that can be supported by arm's-length benchmarks.

To the extent that such agreements do not contain force majeure clauses, or if the force majeure clause does not explicitly cover a global pandemic or types of governmental assistance being provided to companies globally, those agreements are economically incomplete with respect to the disruption created by COVID-19.

The following example provides a more tangible perspective of the difference between a legal analysis of a force majeure clause and an economically incomplete contract.

Assume that a parent company, Entity A, in Country A has contracted with a controlled subsidiary, Entity B, in Country B to perform manufacturing services for Entity A on a contract basis. Entity A sells finished goods purchased from Entity B to end customers in the hospitality industry in Country A. The transaction is memorialized in an intercompany agreement that provides for a reimbursement of all costs plus a profit element for Entity B and has a general force majeure clause that provides for acts of God but does not explicitly incorporate government action.

Due to government mandated shelter-in-place restrictions, the hospitality industry in Country A is heavily disrupted and demand for the finished goods purchased from Entity B has dropped significantly.

Consequently, Entity A is generating losses which are rapidly eroding its cash reserves. What if Entity B's operations have not been impacted by the illness of employees, the disruption in the supply of component parts or government action? The force majeure clause is interpreted to cover uncontrollable situations in which Entity B's ability to fulfill its obligations under the contract are impacted, not to cover instances of economic hardship incurred by Entity A, the payor.

This interpretation means that the contract continues to legally bind the parties. The parties cannot renegotiate pricing, as would likely be observed in uncontrolled transactions, in which the service provider accepts lower payments in an effort to increase the chances that its sole customer survives a temporary reduction in demand due to government action related to the pandemic.

Based on the facts and circumstances, an economic analysis of the intercompany contract concludes that government action related to a pandemic that impacts the demand for Entity A's products was not contemplated in the original negotiation of the agreement, i.e., it is an incomplete contract with respect to the issue at hand, and the related parties should be able to renegotiate.

Unrelated parties can cooperatively renegotiate or dispute economically incomplete contracts, which by extension means that related parties can do the same based on specific facts and circumstances.

One key issue to assess from an economic perspective is whether the changes observed in the midst and immediate aftermath of the pandemic are sufficient to mandate a change. To the extent that these agreements need to be rewritten to mimic arm's-length behavior, there may be very little concurrent, publicly available evidence of arm's-length benchmarks.

Therefore, a renegotiation between controlled parties should take into account relevant issues that may include (1) the original intent of the parties when entering into the arrangement, (2) the likelihood of the impact of COVID-19 being permanent or transitory,[6] (3) the realistic alternatives available to each party, (4) the relative strength of each party's balance sheet, and (5) any governmental assistance made available to either party.

Conclusion

Economic theory on incomplete contracts may be a useful prism through which to consider transfer pricing arrangements as multinational enterprises contemplate the impact of the COVID-19 pandemic on their global operations.

Based on the facts and circumstances, it is possible that an intercompany arrangement that did not provide for the eventuality of a global pandemic on an ex ante basis is economically incomplete. If this is deemed to be the case, then a principled economic analysis may be required to renegotiate the transfer price during the pandemic period in accordance with arm's-length behavior.

Robin Hart is a principal and Steven Schwartz is a vice president at Charles River Associates.

[1] There is extensive literature — developed importantly by Oliver Hart and John Moore, among others — that describes incomplete contracts and models in a formal (i.e., mathematical) way and how contracting parties interact and form contracts that are incomplete.

[2] Oliver Hart and John Moore, "Foundations of Incomplete Contracts" Review of Economic Studies, 66 (1999)115-138. (Hart and Moore 1999).

[3] See Hart and Moore 1999 at 116.

[4] Oliver Hart, who won the Nobel Prize in Economics for his work in this area, says: "…Ex post renegotiation of an incomplete contract occurs under conditions of symmetric information—both parties can see what has been left out of the contract—and that…the bargaining proceeds efficiently." Oliver Hart, "Incomplete Contracts and Control" American Economic Review 2017, 107(7) at 1734.

[5] See, generally, Oliver Hart and John Moore, "Incomplete Contracts and Renegotiation" Econometrica 56(4) July 1988 at 755-785.

[6] In the context of incomplete contracts, the renegotiation that hypothetically could occur in the face of an unresolved issue in the contract will look very different if the parties agree that the change is likely to pass quickly as opposed to one likely to persist over time.