Litigating Force Majeure

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Today’s Discussion

Force Majeure
• Legal Basics
• Key Strategic Issues

Example #1
Supply Chain Disruption
• Causation Analysis
• Mitigation Considerations
• Damages Analysis

Example #2
Construction Delay
Force Majeure
What is Force Majeure?

• From the French for “superior force,” a force majeure event is (a) an extraordinary event or occurrence outside the control of the parties to a contract that (b) prevents one or both parties from fully performing their contractual obligations.

• A force majeure event can be caused by humans (e.g., strike, riot, war, terrorism, governmental action) or nature (e.g., hurricane, earthquake, tornado, pandemic).

• Force majeure is a defense to breach of contract claims.

• Under most contracts, force majeure will release the parties from liability due to any breach caused by the event.
  – Example: A tour company leads an annual corporate retreat on a volcano that was thought to be dormant, but it unexpectedly erupts. Under most force majeure provisions, the tour company would not be liable for breach for cancelling the retreat and would not owe the retreatants damages.

• Depending on the contract and the event, the force majeure event may terminate the contract entirely.
What Happens When a Party Invokes Force Majeure?

- *Force majeure* is a creature of contract, and the precise language of the *force majeure* provision will govern.

- The precise language of the *force majeure* provision may not be clear or definitive in a particular situation.

- A party’s reliance on a *force majeure* provision to excuse non-performance typically involves consideration of the following factors, which may or may not be addressed in the language of the provision, before the party is released from liability.
Basic Elements of *Force Majeure* Declaration

- Unforeseeability
- Outside party control
- Not able to mitigate
- Notification
- Impossibility of performance
Unforeseeability

• *A force majeure* event must not be foreseen by the parties to the contract.

• This can be inferred from the rest of the contract (i.e., is the event discussed elsewhere?) and from extrinsic evidence.

• Did one party agree, explicitly or implicitly, to assume the risk of the event?
  – Look to the contractual representations, warranties, and indemnifications
Outside Party Control

- **Force majeure** events must be caused by something outside the parties’ control, either by intervening human third party or by nature (or both).

- For example, even catastrophic damage caused by one party’s equipment failing is unlikely to be **force majeure** unless the failure is caused by some other event.

- There can be tricky causation questions (see next segment).
Not Able to Mitigate

• The party invoking *force majeure* is typically required to take reasonable steps to mitigate the effects of the event, if possible.

• What is “reasonable?” This depends on the contract and the event.

• There can be difficult mitigation questions (see next segment).
Most contracts contain a notification provision. The party invoking *force majeure* must notify the other party that it is invoking the *force majeure* event within a certain amount of time after the event, or after the party learns of the event.

The time can be quite short, just a few business days in some cases. This can make it difficult for a large company to react.

It can sometimes to be difficult to determine precisely when the *force majeure* event occurred for notice purposes.

- Example: The date a hurricane arrived is easy to determine, while the date that an epidemic caused non-performance is less clear.
Impossibility of Performance

- Does the *force majeure* event make performance of the party’s contractual duties essentially impossible?

- A mere increase in cost is typically not considered to make performance impossible, unless it is so great as to overwhelm the contract.

- Example: A building under construction costs $10 million and is close to completion. A hurricane hits and increases contractor’s costs of finishing the building.
  - This event is unfortunate, but arguably not a *force majeure* if the building can still be finished, but less profitably. However, if the hurricane completely destroys the building, it is likely a *force majeure* and the contractor is not required to start from scratch and rebuild the entire building at no additional cost.
Additional Considerations When Sending Or Receiving A Force Majeure Notification
Other Related Common-Law Defenses

• Impossibility/Impracticability/“Act of God”: Discharges a party from contractual obligations when a basic assumption of the contract is destroyed and such destruction makes performance impossible or impractical
  – Example: A company contracts to regularly service and maintain a ship. The ship sinks in a storm, making the contract impossible to perform.
  – Most jurisdictions’ impossibility defenses are narrower than typical force majeure provisions.

• Frustration of purpose: Similar to impossibility et al., where after a contract is made, some assumption central to the contract becomes false
  – Example: Parties contract to provide vending services to a city’s local sports team, but the team later moves. The team being in the city was a central assumption of the contract which has been frustrated.
Delay or Termination?

• Depending on the nature of the *force majeure* event and the contract, invoking the provision could release a party from liability for breach caused by delay, or could terminate the contract entirely.
  
  – Example: A services contract has a 6-month *force majeure* termination provision. Subsequently, a labor strike makes the contract impossible to perform. If the strike lasts three months, the party may not be liable for damages caused by the three month delay, but the contract is still in effect. However, if the strike lasts for a year, the contract is terminated entirely and both parties walk away.
How Might Declaration Affect Other Contract Relationships?

• A *force majeure* declaration might create issues with other contracts or commercial relationships.

• It can be difficult to declare that an event constitutes *force majeure* to one party, while rejecting another party’s declaration.

• Examples
  – Declaration by primary contractor may make it difficult to contest declaration by subcontractor.
  – Declaration by supplier of built product may make it difficult to contest declaration by component supplier.
Don't Sleep On Your Rights

• The party invoking *force majeure* should provide prompt notice of the event, a clear explanation of how it renders performance impossible, and the extent to which mitigation may or may not be possible.

• A party resisting *force majeure* should communicate promptly to reject the assertion of *force majeure* and explain why it believes that complete or partial performance is still possible.

• Take away: Parties that provide prompt notice and timely, cooperative communication about the *force majeure* event and potential mitigation measures are likely to be seen more favorably by a court or jury.
Example #1 – Supply Chain Disruption
Supply Chain Disruption

• **Los Angeles Inc., (“LA”)** is a privately owned firm that manufactures widgets in Los Angeles.

• **New York Inc., (“NY”)** is a publicly traded firm located in New York that purchases 10 widgets a month from LA and resells them to its own end customers.

• COVID-19 cases begin to appear, and LA and NY are deemed essential businesses by Federal and State governing agencies and are legally allowed to remain open.

• After a month, LA unilaterally halts deliveries, invoking a *force majeure* clause in its supply contract with NY.

• NY closes its business and sues LA for non-performance.
Causation Analysis
Overview

• LA has invoked *force majeure* as the reason for non-performance.
  – There must be a causal link between the *force majeure* event (i.e., COVID-19 or the government’s response) and LA’s failure to perform.

• A causation analysis is typically fact intensive, involving legal, economics, industry, and subject-matter experts.

• Using the widget hypothetical, we outline several generic, non-exhaustive, and non-exclusive elements to consider in a causation analysis.
Economics of Production 101

• Output is a function of inputs and productivity:

\[
\text{Output} = \left(\text{Raw Materials} + \text{Labor} + \text{Land} + \text{Capital}\right) \times \text{Productivity}
\]

• For an output target to be unfeasible, there must be a shortage in input supply.

• For an output target to be unprofitable, we must assess several factors; e.g., prices, costs, market structure.

• We ignore profitability and focus on the stricter test of feasibility that we understand some courts apply when assessing *force majeure*. 
Restricted Inputs Leads to Restricted Output

• **Raw Materials**: Raw materials suppliers might decrease/halt their production due to COVID-19-related factors.

• **Labor**: Workers might fall sick and stay home to prevent contagion or be hospitalized and become unable to work. LA might request that their employees stay home as a safety precaution.

• **Land**: The factory might not be accessible and operational.

• **Capital**: Accounts receivable may default. Does LA still have enough cash to pay workers and obtain supplies?

• **Productivity**: Recommended/mandated distancing between workers might inhibit production processes. Management working from home might impair supervision.
Assessing *Force Majeure* Claim (1 coin, 2 sides)

- LA would seek to establish that one or more inputs were unavailable at a “commercially practicable” price.

- NY would seek to establish that all inputs were available – even if the price was high.
  - Estimate production function (using historical data)
  - Assess availability of those input quantities during period at issue
  - Determine impact of the *force majeure* event on the availability of each input (e.g., consider unrelated labor strike at the same time as COVID-19 outbreak)
LA’s Profitability And Probability Of Successful FM Claim Are Inversely Related

Continuum of Financial Metrics

Profit ($M) vs. FM claim probability (%)

- Decreased profit
- Breaks even
- Covers variable cost
- Draws cash reserves
- Increases debt
- Sells equity
- Solvency risk
- Bankrupt

Financial condition

- Profit ($M)
- FM claim probability (%)
When Does LA Get to Claim *Force Majeure*?

- The threshold for performance is a gray area.
  - Commercially/Economically practicable
  - Commercially/Economically reasonable
  - Sell at a reduced but still positive margin – for how long?
  - Sell at a negative gross margin – for how long?
  - Sell at a negative operating margin – for how long?
  - Sell at a negative net margin – for how long?

- Joint discussion with K&L Gates
Mitigation Considerations
Can LA Mitigate NY’s Damages?

• Were alternate supplies of inputs available (e.g., raw materials, labor)?
  – Increased cost?
  – Time delay?
  – Change in quality or composition?

• Were alternate widgets available?
  – At what price on the open market?
Can NY Mitigate Its Own Damages?

• While LA as breaching party is obligated to mitigate damages caused by its force majeure declaration, NY might also be obligated to mitigate its own damages (i.e., cover) under other legal doctrines.
  – Were alternate supplies of widgets available?
  – When could the alternate widgets have been available?
  – At what extra cost could the alternate widgets have been manufactured and delivered?
  – Would the alternate widgets’ quality have been comparable to that of LA’s widgets?
  – Would the alternate widgets have commanded the same price as LA’s widgets, given demand at the time?
  – Were there any other products or services that NY could have sold instead of widgets?

• Joint discussion with K&L Gates
Damages Analysis
How is NY Damaged?

- Assuming LA’s *force majeure* declaration is improper, NY is entitled to damages.
- A damages analysis typically involves assessing the financial impact from the failure to perform and should be case specific.
  - Relevant time period
  - Lost sales
  - Increased costs
  - Reputational harm
  - Opportunity costs
Time Period Over Which to Assess Damages

• When do damages begin?
  – Upon failure to receive shipment (non-performance)?
  – What if NY has a 3-month supply of widgets stored in a warehouse?

• When do damages end?
  – When shipments resume?
  – When the supply contract with LA expires?
  – When replacement widgets are sourced?
  – What about lost long-term contracts/relationships with purchasers?
Lost Sales Considerations

• Could NY have actually sold all 10 widgets? Did NY’s own end customers decline delivery of widgets?

• Was lost revenue due to reduced prices (e.g., demand for widgets fell)?

• Did NY also lose revenue from non-widget products or services?

• Was NY forced to close their operations for reasons other than LA’s failure to deliver widgets?

• Did NY partly benefit from claimed force majeure event?
  – Example: Did demand for widgets go up, thereby increasing value of any widgets NY had in stock?
How Does One Quantify NY’s Lost Sales?

• Gather and review financial and accounting data
  – Examine existing orders and sales contracts
  – Compare to same-period sales from previous years or month to month
  – Compare to internal business plans and projections
  – Compare to third-party forecasts (e.g., analyst and industry reports)
  – Compare to peer/competitor sales

• Conduct econometric analysis
  – Controls for economy and industry-wide factors (e.g., assume new competitor has recently entered the market)
Increased or Reduced Direct Costs?

• Did NY realize any increased/reduced costs due to LA’s failure to perform?
  – Increased costs to source from third party
  – Decreased costs because operations halted

• Relevant costs may include materials and labor costs, delivery charges, SG&A, legal fees, and other professional fees.

• Variable and fixed costs
  – Costs that change as activity levels change are variable and should be accounted for.
  – Costs that do not vary with volume of activity (at least in the short term) are fixed and should be ignored.
Harm to Reputation

• Was NY’s reputation harmed due to LA’s failure to perform?
  – Reduction in NY’s brand value
  – Reduction in NY’s future business opportunities (lost future contracts)

• How did NY’s rivals act?
  – Were they able to obtain widgets?
  – Did they sell widgets to NY’s customers?
  – Did they engage in a negative marketing campaign against NY?

• Does the economy-wide nature of COVID-19 temper the harm to NY’s reputation (if any)?

• How does one measure reputational harm?
  – Academic literature & event studies for publicly traded companies
Opportunity Costs

• *Opportunity cost* refers to the value of the best foregone alternative use of the resources employed.

• What opportunity costs has NY suffered?
  
  – Assume NY has a growth plan that depends on the profits generated by the sale of 10 widgets. Are those plans ruined?
  
  – In order to address LA’s failure to deliver, was NY forced to expend additional resources such as managerial time or board of directors time (e.g., searching for alternate widget suppliers, dealing with unhappy customers) that either would not have been incurred or could have been spent elsewhere generating new customers and more profit?
Increased Costs of Capital

- As a result of LA’s failure to deliver 10 widgets, NY is unable to sell the 10 widgets and is deprived of the resulting profit.
  - Does NY have to borrow to make up the shortfall?
  - If NY becomes less financially secure, it may face higher borrowing costs.
  - Does NY need to recapitalize at higher cost sources of capital?
Potential Offsets to NY Damages

• Insurance payments: Does some insurance policy offset part of the damages from LA’s non-performance?

• Stimulus payments: Did NY receive financial support through the CARES act or other federal, state, or city policies?
A Note on Event Studies

• Assume that prior to the *force majeure* event, NY’s stock was trading at $20 per share, and the company had a market value of $200 million.

• Event study analysis is a methodology commonly used to estimate the stock price effect or abnormal return of an event.

• An event study analysis estimates that the abnormal return due to the Force Majeure event was -10% or $2 per share, corresponding to a $20 million drop in NY’s market value.

• This is a possible measure of the aggregate harm due to LA’s failure to perform.

• Whether an abnormal stock return is statistically significant depends on the magnitude of the abnormal return relative to the security’s historical price movements or volatility. (Higher historical volatility will result in less abnormal stock returns being statistically significant, ceteris paribus.)
Example #2 – Construction Delay
Construction Delay

- Mall hires Builder to build a retail shopping center with 20 units by December 2020.
- COVID-19 cases begin to appear, and the local government enacts social distancing guidelines and work restrictions.
- Builder claims construction cannot continue and invokes *force majeure* as reason for non-performance.
- Social distancing guidelines are gradually rescinded, and Builder is allowed partial work crews.
- Builder finishes construction in December 2021, twelve months after the contracted completion date.
- Mall sues Builder for non-performance.
Causation – Mitigation – Damages

• Causation Analysis (1 coin, 2 sides)
  – Assess production function and whether inputs were restricted
    
    Output = [(Raw Materials + Labor + Land + Capital) * Productivity]

• Mall Mitigation Considerations
  – Supply; Timing; Cost; Quality

• Damages Analysis
  – Relevant time period
  – Lost sales
  – Increased costs
  – Reputational harm
  – Opportunity costs
Broad Applicability
Applicable to More Than Just *Force Majeure*...

- The concepts covered in this presentation have a broad applicability:
  - Material Adverse Change Clauses
  - Corporate Fraud
  - Breach of Contract
  - Insurance Coverage
  - Negligence
  - Commercial Damages
Any Questions?

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