Force Majeure and Covid-19

March 25, 2020

The global health crisis brought on by the spread of the Novel Coronavirus ("COVID-19") continues to affect businesses of all sizes. This is causing uncertainty in businesses' ability, or inability, to meet its contractual obligations. Looking to stop the spread of this virus, municipalities, cities, states and countries are issuing shelter-in-place, self-isolation and movement restriction orders grinding the gears of the economy to a halt.

In the last few days alone, the cities of Los Angeles, San Francisco and several others, along with the states of California, New York, Illinois and Connecticut, issued what amounts to shelter-in-place orders for all but essential businesses. President Trump has invoked the Defense Production Act, putting into place emergency wartime powers, and has declared New York and California as a "major disaster" area and is considering labeling many other states the same.

In total, at least 75 million people are subject to a shelter-in-place or similar type of order. And there are reports of numerous other states implementing orders similar to California and New York.

These are unprecedented events. Countless businesses are forced to shutter their operations. Supply chains have been disrupted in nearly all market sectors and at all levels. Events, gatherings and conferences of all types have been cancelled. The health and safety of each companies' individual stakeholders—employees, customers, suppliers, and shareholders—is of the utmost concern. But the economic impact of this pandemic is impossible to ignore. These impacts are illustrated nowhere better than in the securities and futures markets, with the Dow Jones Industrial Average declining by more than one-third, and the price of a barrel of benchmark oil by more than one-half, in the thirty days preceding the date of this bulletin. The Federal Reserve Board's Federal Open Markets Committee has taken extraordinary steps to assure liquidity to the banking system and, along with other unprecedented steps, has reduced the federal funds interest rates to as low as zero. This climate has resulted in a dramatic reduction in deployment of capital by investors and lenders and has made it extraordinarily difficult to continue pending transactions that had not already been subjected to binding agreements. And even those agreements are, in some cases, exposed to risk and uncertainties associated with "force majeure," "material adverse change," or "market out" clauses.

What is a business to do with its contractual obligations in the face of this mounting uncertainty and forced idling? Many are looking to *force majeure* clauses and the related principles to determine whether they have an opportunity to terminate, restructure or renegotiate contractual relationships of all sorts. The related concepts of material adverse change, material adverse effect and "market outs" are based much more substantially on the language of the affected contract, but because the events and conditions that give rise to them are similar, we

believe that a thorough appreciation for *force majeure* principles may help parties assessing compliance with those provisions as well.

***Force Majeure* Clause: What is it and how does it work?**

Many commercial contracts include a *force majeure* clause. Essentially, a *force majeure* clause excuses a contracted party's nonperformance if certain unforeseeable, and typically generalized, events set forth in the clause occur after the contract is formed. The occurrence of such an unforeseen event must make performing the party's obligation difficult, impossible or delayed and could not have been avoided or overcome by the "prudence, diligence or care" of the performing party. The doctrine of *force majeure* is not intended to shield a party from normal business risks assumed by a party when they entered into a contractual relationship. Instead, these clauses are meant to protect a contracting party from consequences or events beyond the "party's control [or reasonable control] and [occur] without its fault or negligence."

Additionally, in both Delaware and California, economic hardship alone does not excuse nonperformance under the *force majeure* clause. Thus a party that merely incurs more expenses than anticipated does not have their nonperformance excused under a *force majeure* clause, even if negotiated. California courts, however, do provide relief if there exists "extreme and unreasonable difficulty, expense, injury or loss involved." Therefore a court could afford a party relief if it faces an insurmountable expense associated with performing the contract.

In the case of a *force majeure* clause, these contractual provisions typically contain boilerplate language. The application of a *force majeure* clause in each situation, however, is dependent on the party's specific facts and circumstances and the applicable provisions' language. And to the dismay of many businesses currently evaluating their agreements, they are uniquely applied based on the commercial transaction at hand.

Typically, *force majeure* clauses provide that a party is not liable or responsible to its counterparty, nor have they breached the contract, if performance is prevented or delayed as a result of the occurrence of an unforeseeable event of the type listed in the provision. The *force majeure* events listed in such clauses are broad in scope and typically include: "war", "acts of god", "acts of terrorism", "strikes", "government regulations or orders", and "disasters." Some *force majeure* clauses include "pandemics" or "epidemics" as a listed event, but many do not (although, of course, one can assume that this issue will become common practice in light of today's historic events).

The applicability of a *force majeure* clause is based on the occurrence of a specific unforeseeable event and contractual interpretation. For example, California and Delaware courts will narrowly construe such *force majeure* clauses and look to the words chosen by the drafter. This means that if an event occurs but such does not fall under a *force majeure* event listed in the contract, then nonperformance is not excused under the *force majeure* clause even if the event prevents performance (although there are other contractual remedies that excuse nonperformance, see "Alternatives if there is no *force majeure* clause" below). Importantly, under the canons of contractual interpretation, courts will interpret the meaning of each word based on the other items listed. For

example, if the listed *force majeure* events only relate to disasters and war, but do not include sickness or disease, then the use of "act of god" or "other similar events" in the clause may not apply to a disease outbreak—such as COVID-19—but probably would be construed to apply to a disaster or act of hostility not included in the list.

Note the treatment of a *force majeure* clause, although related, is distinct from a "material adverse effect" ("MAE") clause contained in many pending transaction agreements, such as in the mergers and acquisitions context. Although the concept is similar, an MAE clause is a highly detailed provision detailing the events, conditions or circumstances that are expressly included in or excluded from the definition of the term. Further, an MAE clause is triggered if the event that occurs is both material and adverse to the transaction and is within the set of specifically listed items defining what an MAE is. It is important to note that the occurrence of an MAE, and the subsequent availability of the remedy, does not rely on the foreseeability of the underlying event, like a *force majeure* clause typically does.

What to do if an event occurs

After an event occurs that the party believes is within the scope of its *force majeure* clause, three items must be assessed before triggering such clause.

First, the impacted party must determine the impact to its contractual obligation and whether performance is delayed or prevented because of the event or, if performance is still possible, whether "extreme and unreasonable difficulty, expense, injury or loss [is] involved" in performing its obligations.

Second, the impacted party should assess whether the event was beyond its control, or reasonable control, and occurred without the impacted party's fault or negligence. It is important to note again that a mere increase in expense to perform does not excuse the party's obligation to perform under the contract.

Third, the impacted party should determine whether reasonable steps were or can be taken to ensure performance.

If the party determines a *force majeure* event occurred, then *force majeure* clauses typically require notice and mitigation of damages. That is, once the *force majeure* event occurs, the impacted party must notify its counterparty of such *force majeure* event and that such event is impacting its performance. Then, the impacted party must take steps to minimize, or mitigate, the effects and damages associated with such *force majeure* event.

Therefore, in the situation of the current COVID-19 pandemic, each effected business must carefully determine whether this pandemic falls within the scope of its specific *force majeure* clause. Even if the words "pandemic" or "epidemic" are not listed, it is possible that such an event could be considered an "act of god" or fall under another term in the clause. Such interpretation, however, may be risky because a court may, applying strict interpretation, consider that an "act of god" or such other term, in light of the other events listed, does not include a pandemic or epidemic. Further, it is the impacted party's burden to prove that COVID-19, or the related steps

governments around the world have taken, such as the various measures forcing the closure of nonessential businesses, is the actual and proximate cause preventing or delaying performance. Additionally, the impacted party must prove that such prevention or delay could not be overcome without risk of extreme or unreasonable expense, loss or injury. It is not a stretch of the imagination, however, that the forced shutting down of a factory for up to and maybe more than a month, as a result of a pandemic that has infected over 300,000 people, is an insurmountable and unforeseen event that cannot be prevented. Thus triggering the *force majeure* clause.

Steps to take to protect your *force majeure* rights

In these times of crises, parties evaluating whether they should trigger their *force majeure* clause should take steps to document and keep good records of their process, including:

- The interruptions to the business, the causes, effects on its operations and the extent of such interruption;
- Whether the interruption to the business is typical to the type of business or industry it is involved in or whether the interruption is outside the control of the party and typically not an assumed business risk;
- The location of where the business has been effected and the location performance is to be undertaken under the contract;
- The party's consideration of whether there are any alternative methods of performance and whether performance can be effectively delayed or postponed to a future period;
- Any and all correspondence with the counterparty, whether to or from, communicating the impact of the current events on the businesses' operations;
- How the party came to its conclusion that a *force majeure* event occurred; and
- Lastly, the notice it provided to the counterparty and any mitigation efforts.

Taking these steps listed above and documenting the party's considerations with counsel is imperative to protect the business in the event of any eventual litigation and preserve this remedy.

Alternatives if there is no *force majeure* clause

Notwithstanding, if your contract does not contain a *force majeure* clause, the law provides a number of other options to excuse your contractual obligations in times like these. These options include illegality, impossibility, impracticability, unilateral or mutual mistake of fact, and frustration of purpose. Note, however, each of the aforementioned remedies is highly fact-dependent on the transaction and each party's specific situation. Further, courts typically apply a more rigorous standard to excuse a party's nonperformance under one of these remedies than under a *force majeure* clause. Therefore, it is important to document and record the party's situation consistent with the steps listed above.

It may be appropriate for a business to attempt to negotiate a mutually beneficial outcome and preserve the business relationship. However, the COVID-19 pandemic is a rapidly evolving situation and such an outcome may

not be feasible. Therefore, before asserting any contractual remedy, parties should take caution to carefully review and understand their contracts and heed the advice of counsel.

The current environment is uncertain. At Buchalter, we are here to help and are uniquely positioned to address all of your needs to effectively navigate you through this time of crisis.

If we can be of assistance and to discuss various options and specific situations, please feel free to contact any of the Buchalter Corporate Attorneys below.

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