Katten

CORPORATE AND COMMERCIAL LITIGATION ADVISORY

Force Majeure: A Practical Perspective for Commercial Relationships

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In the wake of the COVID-19 pandemic, businesses are increasingly considering whether force majeure clauses, a common provision that can excuse a party from having to fulfill contractual obligations when unforeseeable circumstances occur, apply to their situation. This advisory provides insight into the general applicability of force majeure clauses and offers a practical, business oriented approach to addressing force majeure issues.

What is "Force Majeure"?

Force majeure clauses attempt to allocate the risks of unexpected events that are — by their very nature — unforeseeable. Thus, regardless of how carefully negotiated and drafted a force majeure clause might be, it involves a degree of uncertainty.

The COVID-19 pandemic has brought force majeure clauses into sharp focus. The disruption of commerce across industries has commercial parties wondering whether, and to what extent, force majeure clauses can excuse their or their counterparties' performance — and, relatedly, what steps they can take now to minimize the risk of force majeure litigation down the line.

The first step in any force majeure analysis is to address whether the force majeure clause applies. The next step is to ask whether the catastrophic event has rendered performance impossible or merely difficult — and, if the latter, what steps can and should be taken to effect performance. The answers to these two questions help inform how a business should approach the situation from a practical standpoint.

Question One: Does the Force Majeure Clause Apply in This Situation?

Force majeure is an issue of contract interpretation and thus governed by state law — usually the law of the state governing the contract. For matters involving certain industries, cases outside the jurisdiction may be instructive as to the "custom in the trade" for handling disruptions in the marketplace.

Generally, determining whether a force majeure provision applies focuses on three factors:

1. ***The Event Must Fall Within the Terms of the Force Majeure Clause.*** Any force majeure analysis begins with the wording of the contractual provision itself. In general, courts will strictly construe the language of a force majeure clause, making the specific wording of the clause important. The language of a force majeure clause usually follows one of two patterns:

    - Pattern 1: "Force majeure means x event, y event and z event." With this construction, courts tend to limit the applicability of force majeure to those specifically enumerated events. Accordingly, if a pandemic or governmental action (*e.g.*, a stay at home order or the closure of certain types of businesses) is not listed, there is no force majeure, even if performance was, in fact, impossible.

- Pattern 2: "Force majeure means any event beyond the reasonable control of a party, including, without limitation, [laundry list of events]." The Pattern 2 construction is overwhelmingly more common. With Pattern 2, some courts simply ignore the catch-all "without limitation" and treat the provision as if it were Pattern 1. More typically, however, courts will treat an unlisted event as a force majeure, if it is of a type similar to those events listed.

2. ***The Force Majeure Event and its Consequences Must Not Have Been Foreseeable.*** Force majeure events are, by definition, unforeseeable. The foreseeability factor encompasses two questions:

   - First, courts ask whether the parties could have foreseen the force majeure event itself at the time they formed the contract. Essentially, the question is whether the parties could (and therefore should) have taken this risk into account when they were negotiating and drafting the contract. The "classic" force majeure events — floods, hurricanes and other "acts of God" outside of human control — are examples of events the law treats as unforeseeable.

   - Second, courts ask whether the *effect* of the force majeure event was foreseeable. This second question is more nuanced. For example, if a hurricane destroys the roads a shipper typically uses to transport its goods, forcing the shipper to incur costs and delays involved in taking more roundabout shipping routes, a court may ask whether delays as a result of re-routing were foreseeable. If the parties could foresee that the usual trade routes could become unusable for a reason other than a natural disaster (such as construction), the additional costs caused by delays might also be foreseeable. In this regard, changes in the party's business or in the marketplace, even if caused by a force majeure event, tend not to be viewed by courts as unforeseeable.

3. ***The Force Majeure Event Must Be the Proximate Cause of the Failure to Perform.*** The proximity of the connection between the unforeseeable event and the inability to perform is also crucial to the force majeure analysis. The more intervening steps between an unforeseen event and non-performance of a contract, the less likely a court may be able to find that the event provides a legal excuse for the failure to perform.

   Oftentimes, causation is a simple matter. Think of the "classic" force majeure situation: Lightning strikes a factory, and the factory is destroyed, preventing the manufacturer from making products under contract. The force majeure event was both the direct and proximate (legal) cause for the manufacturer's failure to perform.

   The causation question becomes more complicated, however, when events or circumstances other than the force majeure event contribute to the failure to perform. Consider, for example, if instead of destroying the manufacturer's factory, lightning demolished a supplier's factory that produced the primary component of the manufacturer's product. Even if such event caused a scarcity of the component or its price to skyrocket, the fact that the manufacturer is one step removed from the force majeure event decreases the likelihood that a court will find that the proximate causation requirement is met.

Question Two: Is Performance Impossible or Merely Difficult, and What Steps Must be Taken to Effect Performance?

If an event was unforeseeable and was a legally sufficient cause to excuse performance, the courts next ask whether performance is impossible or whether performance is possible but costly or burdensome. If performance is truly impossible, courts will not require a contract party to perform an impossible task. However, in the more likely scenario, performance is not rendered impossible but rather burdensome or costly (even if extraordinarily so). In these cases, the non-performing party has an obligation to do something to alleviate or overcome the difficulty

caused by the force majeure event — the party must act reasonably and make a bona fide effort to continue to perform to the extent possible.

Unfortunately, "reasonable efforts" are open to interpretation. There is no clear guidance as to the extent to which a party must expend additional resources in order to perform. However, where a force majeure event causes some change in the business or marketplace which, in turn, leads to non-performance, the burden on the non-performing party is rather heavy. Although a company need not go bankrupt in order to perform, the fact that performance would be merely expensive or unprofitable is not sufficient. Alternative arrangements should be explored notwithstanding increased costs. For example, in a service business in which the location of performance of the service is not critical, regardless of the expense, the failure to continue to perform to some extent from a secondary location (*e.g.*, a home office) would likely result in a failure of the force majeure defense. Similarly, if a party has a business continuity plan in place, failure to fully implement such plan (and incur the resulting costs) could also doom the defense.

Question Three: How Should Businesses Approach This Force Majeure Event From a Practical Standpoint?

Force majeure clauses do not exist in a vacuum. They must be understood as part of the parties' overall relationship. Commercial contracts often reflect ongoing commercial relationships, which may have existed, and could continue to exist, for years. In these instances, even if a party could successfully mount a force majeure defense, doing so may terminate the contract or otherwise jeopardize the commercial relationship going forward. In such situations, it may be worthwhile to (1) determine the most efficient means of renewing performance (in whole or in part) and (2) in the meantime, help the counterparty find a different, and hopefully temporary, alternative performance. Working with the counterparty to help alleviate the harm of the force majeure event will go a long way to maintaining the relationship for the future.

If the force majeure event has not rendered performance impossible but has merely made it more expensive and/or burdensome, there are a few steps to take that may be helpful in avoiding future litigation and maintaining commercial relationships:

- Give prompt notice. When in doubt about whether a force majeure defense will succeed, act as if you are in a classic force majeure situation. There is no need to cite to the provision in your correspondence (which will certainly cause the other party to pull their copy of the contract and send it to their lawyer), but you should provide prompt notice of the cause and effect of non-performance, even in the absence of any requirement of notice in the force majeure clause.
- Plan to spend money to ameliorate the situation. As noted above, there is no easy answer to how much you must spend or the lengths to which you must go. Engage in the same risk/reward analysis that you do for other major business decisions.
- Be fully transparent. Let the other party know what you are doing to rectify the situation. Let them know that you are expending substantial efforts and monies to renew performance, provide a timetable for resumption of full performance, and give the impression that you are going "above and beyond."
- Compromise. If it is not your performance that has been impeded or prevented but your counterparty's, take the same business-oriented approach and remain open to compromise. After all, the COVID-19 crisis affects everyone and will eventually end, and a more cooperative approach will go further toward preserving the commercial relationship than will threats of litigation or a hardline approach.

Longtime business relationships are often described by the parties themselves as "partnerships." In the uncertain commercial environment precipitated by COVID-19, keeping communication open, acting in good faith and using "best efforts" (as that term is generally understood by business people — not lawyers) go a long way toward having the parties treat the situation as a commercial matter and not an adversarial one.

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