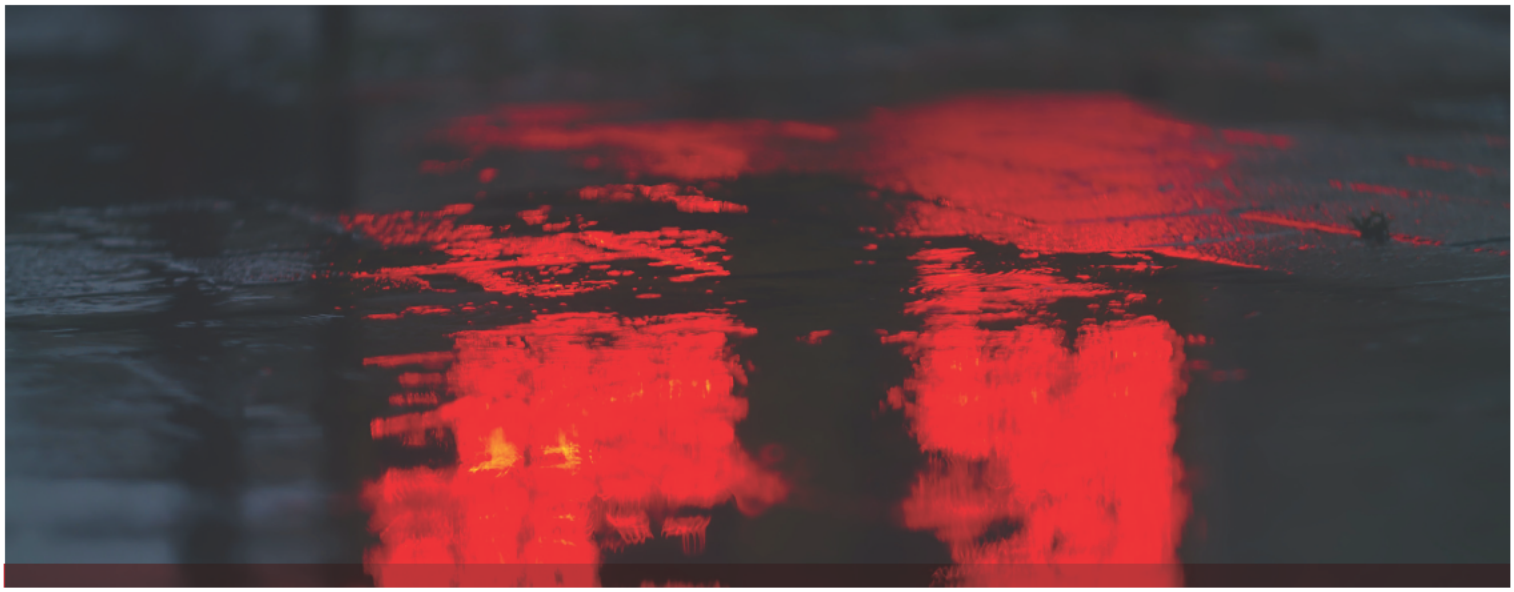
Interpreting Force Majeure and Material Adverse Change Clauses in the Wake of COVID-19

EDWARD J. BUTHUSIEM, BRIANNON IRWIN, AND RYAN BRUBAKER



The novel coronavirus (COVID-19) pandemic is straining the global economy as governments implement increasingly stringent restrictions on daily activities, and, as a result, a sense of uncertainty is pervasive among investors. These economic concerns have burdened businesses in nearly every sector, presenting companies with new challenges to solvency and profitability—and little time to prepare.

The highly fluid nature of the pandemic and the attendant closure of many businesses, government offices, and public spaces has given rise to complications and—in some cases—an inability to fulfill contractual obligations. Parties are seeking to invoke the pandemic to enforce force majeure and material adverse event (MAE) contractual provisions to excuse contractual performance. Thus, it is more important now than ever before to consider thoroughly how the current economic and public health landscape could interfere with contractual assignments of risk and traditional avenues for recourse.

Force majeure provisions are a type of contractual mechanism used to protect parties against extenuating circumstances beyond the control of the parties that preclude their ability to perform under contract. Force majeure is raised most often as an affirmative defense to allegations of breach of contract. Circumstances that are commonly used as a basis for the defense—such as natural disasters, war, political instability, and other "black swan" events—may be explicitly included as part of the language in the clause.

Frequently, however, force majeure provisions also contain a "catch all" to cover unforeseen situations that would be difficult to account for in advance, typically referred to as "acts of God." For example, one court defined an act of God as "an unusual, extraordinary, sudden, and unexpected, manifestation of the forces of nature which man cannot resist" such that the injury caused is "due directly and exclusively to natural causes which could not have been prevented by the exercise of reasonable care and foresight."[1]

1 Greene v. Fox Crossing, Inc., 754 So. 2d 339 (La. App. 2d Cir. 2000).

Although the requirements to demonstrate force majeure differ by jurisdiction, a party claiming force majeure generally must show both that the circumstances at hand were outside the "reasonable control" of the party and that those circumstances prevented the party from fulfilling its contractual obligations. For example, in *Watson Labs v. Rhone-Poulenc Rorer*, Watson Labs sued Rhone for breach of a supply agreement related to a drug that Rhone produced exclusively after the US Food and Drug Administration (FDA) shut down Rhone's manufacturing plant due to compliance breaches. The district court rejected Rhone's force majeure defense because preventing the FDA shutdown of the plant was within the "reasonable control" of Rhone—the regulations that Rhone breached and that led to the FDA shutdown were on the books before the parties had entered into the supply agreement.

Critically, the language of the agreement between the parties controls, even where the court does determine that a force majeure event occurred. Where, for example, a contract omits inclusion of a force majeure provision, the courts are reluctant to allow a force majeure defense to excuse performance. For example, Alleppo's Grill, a restaurant in Houston, raised force majeure as a defense to the landlord's breach of contract claim for failure to pay rent after the restaurant was destroyed by Hurricane Harvey. The court recognized that Hurricane Harvey was an act of God, noting that Harvey was a "2000-year storm that could not have been reasonably expected or provided against."[2] However, because the parties did not have a force majeure clause in their lease agreement, the court ultimately decided that Alleppo's Grill could not avail itself of that defense.

Although force majeure clauses apply only in narrow circumstances, businesses whose contracts contain poorly worded clauses—or lack protective force majeure language altogether—may have other avenues to avoid the consequences of breaching a binding agreement.

Material adverse event clauses protect parties similarly against unlikely circumstances that impact the business severely but do not necessarily constitute an act of God. MAE provisions are included most commonly as part of commercial agreements so that the acquiring party may hedge against acute events that significantly lower the value of the assets being acquired. Common scenarios in which MAE clauses are invoked include contract cancellations for the company being acquired, compliance breaches that disrupt production, negative publicity that triggers a sell-off in stock, or any other event that causes an acute decline in a firm's value. For example, if a company being acquired suddenly experienced numerous contract cancellations due to the stay-at-home orders issued in response to COVID-19, the potential acquirer may seek to invoke an MAE clause to rescind the acquisition (if completed) or terminate a definitive agreement prior to completion.

MAE defenses are distinct from force majeure in terms of the type of protection they provide and the parameters under which they may be successfully invoked. While force majeure can suspend or modify the invoking party's contractual obligations for the duration of the event in question, MAE claims—when determined to be applicable—may allow the invoking party to terminate the agreement completely. For example, in Fresenius ***Kabi v. Akorn***, Akorn's income and earnings dropped by over 100 percent due to unforeseen market competition and contract cancellations soon after Fresenius Kabi entered an agreement to acquire Akorn. The court held that Fresenius Kabi could renege on its commitment to complete the acquisition without consequence pursuant to the MAE clause in the agreement, reasoning that the decrease in Akorn's value would have deterred Fresenius from entering into the agreement in the first place.

The COVID-19 pandemic presents a highly unusual set of circumstances under which parties may seek to assert—or defend the assertion of—force majeure and MAE clauses to excuse performance. While it remains unclear how courts will rule in such disputes, recent comments from government officials in the United States suggest that federal agencies are likely to view COVID-19 as an act of God and may grant extensions to companies in meeting compliance requirements or adjudicating underperformance issues. For example, a representative for the Environmental Protection Agency recently stated that the EPA was "aware of the potential impact the threat of Covid-19 may have on facility operations," and that the agency "will evaluate requests to invoke force majeure or extension provisions of enforcement agreements on a case-by-case basis."[3]

2 Bayou Place LP v. Alleppo's Grill, Inc., No. RDB-18-2855, 2020 BL 94789, 2020 Us Dist Lexis 43960 (D. Md. Mar. 13, 2020).
3 Stephen Lee and Amena H. Saiyid, "Companies Asking EPA for 'Act of God' Extensions Due to Virus," Bloomberg (Mar. 20, 2020).

Given that COVID-19 could present difficulties in fulfilling contractual duties in a variety of different ways—including supply chain disruptions, worker shortages, and workspace closures—courts, like federal agencies, will determine the legitimacy of claims on a case-by-case basis. However, with any type of challenge in contract performance related to COVID-19, prudent companies can take a number of actions to protect themselves from unnecessary penalties and risk exposure moving forward:

- Include explicit force majeure and MAE clauses in all agreements. As *Bayou Place LP v. Alleppo's Grill* demonstrates, failure to include a force majeure provision in a contract may leave the invoking party without recourse, even when circumstances might reasonably be interpreted as an act of God. While some jurisdictions may excuse a party from its obligations if performance becomes impossible or impracticable, even in the absence of a force majeure or MAE clause, these doctrines are applied narrowly and cannot always be relied upon.
- Pay special attention at the drafting stage to the language of the clauses, rather than using boilerplate language that can be rejected by courts as overly broad.
- When faced with a scenario that may fall into the remit of a force majeure or MAE clause, take all reasonable actions to fulfill contractual obligations and mitigate harm. As the invoking party in *Watson v. Rhone* discovered, courts will most likely reject a force majeure or MAE defense when the party failed to take reasonable actions necessary to prevent the event leading to the failure to perform.
- Notify federal agencies or counterparties to agreements in advance when it is clear that you will not be able to meet your contractual obligations. Doing so gives both parties ample time to react and correct course, making it less likely that the circumstances will lead to an ugly dispute.

BRG professionals have significant experience performing compliance program effectiveness and risk assessments for companies of all sizes. BRG stands ready to advise companies across various sectors regarding the implementation and improvement of effective compliance programs, the development and review of policies and procedures, and the detection and mitigation of risks.

For further information, please contact Edward J. Buthusiem at ebuthusiem@thinkbrg.com

About BRG

Berkeley Research Group (BRG) is a global consulting firm that helps leading organizations advance in three key areas: disputes and investigations, corporate finance, and strategy and operations. Headquartered in California with offices around the world, we are an integrated group of experts, industry leaders, academics, data scientists, and professionals working beyond borders and disciplines. We harness our collective expertise to deliver the inspired insights and practical strategies our clients need to stay ahead of what's next.

THINKBRG.COM