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Practice Update

Considerations of Force Majeure Defense in Supply Contracts

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By Jamie B. Shyman and Lawrence P. Rochefort

Generally, the invocation of a *force majeure* clause in a commercial contract relieves the parties of their obligations under the contract when unforeseeable circumstances beyond their control render performance impossible. However, the party seeking to invoke a *force majeure* defense – setting aside threshold considerations of the existence, language, and applicability of the *force majeure* provision – must demonstrate that all means of performance are commercially impracticable in order to avoid liability. Because proving "commercial impracticability" can be a nuanced affair and, on the flip side, strictly enforcing contract terms in the face of non-performance can negatively affect long-term business goals, the contracting parties must carefully evaluate the circumstances and conditions giving rise to and responding to a *force majeure* event with respect to their supply contracts. The supplier must demonstrate that it has explored and exhausted all reasonable alternatives before concluding that its performance was impracticable or impossible and invoking this clause. In turn, the buyer/end-user must gather all pertinent information in order to react to the changing circumstances in its upstream supply chain.

Today, the novel coronavirus pandemic represents much more than a mere complicating factor for many commercial businesses. For example, in

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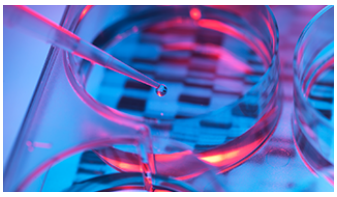

response to the novel coronavirus pandemic, a California State Executive Order provides, in relevant part, that "all individuals living in the State of California to stay home or at their place of residence except as needed to maintain continuity of operations of the federal critical infrastructure sectors[.]" And a New York State Executive Order provides "[a]ll businesses and not-for-profit entities in the state shall utilize, to the maximum extent possible, any telecommuting or work from home procedures that they can safely utilize. Each employer shall reduce the in-person workforce at any work locations by 100% no later than March 22 at 8 p.m." Such state-wide executive orders cause varied circumstances among their state residents including resulting supply chain disruption to non-essential business owners. But, in order to invoke the *force majeure* defense, the non-performing party must demonstrate that the unforeseen pandemic-related extenuating circumstances are causing the impossibility of performance for their business, and that production time problems and/or general supply chain disruption are not causing mere inconvenience or an economic hardship, but the commercial impossibility of performance.

Jennie-O Foods Inc. v. United States, 580 F.2d 400 (Ct. Cl. 1978) demonstrates the relatively high burden that a supplier of a government contract was required to meet in order to invoke a *force majeure* defense while claiming an "epidemic" affected its upstream supply chain. In that case, the supplying party failed to make timely delivery of processed turkeys pursuant to its contract with the Department of Agriculture. The supplier claimed that it did not have access to a supply of healthy turkeys because two of its major suppliers were experiencing disease problems with their flocks. Relying on the term "epidemic" in its contract, the supplier sought to demonstrate that the turkey diseases reached epidemic proportions at its two supplier farms in order to excuse its performance. In fact, the supplier provided two letters from its key suppliers, who were also veterinarians, confirming the diseases of

cholera and avian influenza in their turkey flocks. Ultimately, the Court held that the production time problems that the supplier encountered were due to its own limited facilities, diseased supplies, and allocation decisions. Specifically, the Court found that the cholera and influenza were, indeed, a "complicating factor for plaintiff, but not so sudden, catastrophic, or widespread as to represent more than an economic hardship factor." In addition, the Court found that the contract specifically provided that in order for the supplier to take advantage of the excuse of epidemics or some other excusable delay factor, it must also be found that such an excuse was beyond its control and without its fault or negligence. Thus, the contractor was unable to prove impossibility of performance of the contract, as required, because the contractor simply did not do enough to obtain an adequate supply of healthy turkeys to meet its contractual obligations. While the contractor demonstrated an economic hardship, he did not show impossibility of performance.

Supplier-Side Considerations:

1. **Track Impacts:** In order to claim an excusable delay, suppliers must demonstrate that their failure to perform was sustained by reason of the unforeseen circumstance which is outside of their control. The company should identify the exact cause and nature of any problems. The impact can be varied. To the extent that the company's ability to produce goods or provide services is impacted, those impacts should be specifically memorialized.
2. **Establish Causal Connection:** Though businesses today are increasingly dependent on widespread supply chain networks, claims of the general impact of the extenuating and unforeseeable circumstances on the upstream supply chain is not enough. To avoid liability for non-performance, suppliers must demonstrate the causal relationship between, for instance, the state-wide orders resulting from the global health pandemic and their failure to perform/supply the

goods contracted for. The failure to perform must be due to something outside the supplier's control *and* caused by the pandemic-causing circumstances.

3. **Evidence of Mitigation efforts:** The non-performing party must demonstrate that they took all reasonable actions to perform the contract notwithstanding the occurrence of the unforeseeable circumstances excusing their performance. Stated differently, some courts have found that suppliers must show that alternative methods of supplying such goods became "commercially senseless" in order to invoke the defense.
4. **Communicate:** By sending notice, in writing, to the adverse party relaying the decision to suspend business operations or not supply goods, as contracted for, the non-performing party can trigger certain notice provisions under the contract and affirmatively reserve its contractual rights. Such communications also open the door for reciprocal exchanges with their counter-party, can advise of their reasonable expectations for resuming operations, and can avoid misunderstandings.

Responding Party's Considerations:

1. **Solicit Information:** The company responding to notice of a *force majeure* event should request specific evidence of the circumstance(s) preventing performance. The buyer/end-user should not accept, for example, that certain circumstances constitute a *force majeure* event on the mere possibility of a delay to the upstream supply chain or higher economic consequences from the pandemic-related disruption.
2. **Examine Mitigation Efforts:** Make inquiries regarding how the supplier plans to mitigate the impact of non-performance. The more information the end-user receives the better it can plan its operation or mitigate the impact to its

own operations by altering activities given the unavailability of its upstream supplier's goods.

3. **Analyze Contractual Terms:** Assess whether the coronavirus specifically constitutes a *force majeure* event under the terms of the commercial contract. Evaluate whether there are limitations on claiming *force majeure* under the contract, under local law or with respect to alternative dispute resolution clauses.
4. **Communicate:** Reserve all pertinent rights under the contract including the right to terminate if the *force majeure* event continues for an extended period of time. However, avoid inadvertently waiving contractual or legal rights in your response. While the declaration of *force majeure* may relieve both seller and buyer of their contractual obligations, the end-user should consider maintaining a long-term view of the strength of their commercial relationships in determining whether to strictly enforce contractual rights to seek alternative supplies and/or terminate.
5. **State-by-State:**

- **California Example:** In *Watson Laboratories, Inc. v. Rhone-Poulenc Rorer, Inc.*, 178 F.Supp.2d 1099 (C.D. Cal, Apr. 20, 2001), the issue was whether the FDA's shutdown of the plant that a supplier was using to produce a hypertension drug, excused the supplier's breach of its agreement with a pharmaceutical company under the *force majeure* provision. The supplier argued that the plant was the only plant approved by the FDA to manufacture that drug, that they were not obligated to maintain the capacity to manufacture the drug at another site, and that the FDA's closure was beyond reasonable control, triggering their *force majeure* defense. Meanwhile, the pharmaceutical company argued that the government shutdown of the plant does not qualify as a *force majeure* event because it was both foreseeable, given the plant's past violations, and could have been avoided had the supplier

exercised reasonable control over the plant. Ultimately, the Court found that the FDA shutdown of the plant was a governmental action that, at some level, contributed to the supplier's failure to supply, however the supplier could not rely on *force majeure* to excuse their non-performance because, among other things, the *force majeure* clause did not permit the parties to point to the plant shut-down as an event encompassed by provision. In addition, the supplier could only escape liability if the shutdown was "beyond the reasonable control of either party" which was a factual question with respect to "control", but one that the court believed could be established at trial.

- **Texas Example:** In *Sherwin Alumina L.P. v. AluChem, Inc.*, 512 F.Supp.2d 957 (Corpus Christi Division, S.D. TX, Mar. 19, 2007) Sherwin Alumina produced a product for AluChem using its "kiln 8" existing equipment. Sherwin Alumina's manufacturing process on kiln 8 was under a permit from a Texas environmental quality commission, which required Sherwin Alumina to report certain dust emission events. Although the overseeing agency never ordered Sherwin Alumina to make repairs, issued fines or shut down kiln 8 despite repeated dust emissions, Sherwin Alumina later sought to terminate their supply agreement with AluChem under the *force majeure* provision of their contract, claiming environmental concerns stemming from the dust emission events. Thereafter, Sherwin Alumina withdrew its *force majeure* position, but only agreed to supply the product to AluChem under certain controlled conditions at a higher price. Sherwin Alumina claims that it is excused from further performance under the supply agreement based on the *force majeure* clause because it is not within Sherwin Alumina's reasonable control to avoid violation of the requirements of its air permit without having to purchase new equipment to be able to manufacture the AluChem products. Ultimately, the Court held that Sherwin Alumina was not entitled to declare *force*

majeure "because the costs of compliance were higher than Sherwin Alumina would have liked or anticipated." The Court found that it was within Sherwin Alumina's reasonable control to continue performance under the supply agreement in that the dust emission standard for kiln 8 could be achieved with capital investment such that a dust-free operation of kiln 8 is obtainable, though at a higher economic cost. In addition, the Court found that a contracting party can't declare *force majeure* on the mere possibility of an air violation action because the facts show that the reviewing agency never compelled Sherwin Alumina to shutdown kiln 8 nor gave any indication that it would revoke its permit to produce.

- **New York Example:** In *PT Kaltim Prima Coal v. AES Barbers Point, Inc.*, 180 F.Supp.2d 475 (S.D.N.Y. 2001), the issue centered on whether a labor strike at the coal seller's facility was an event of *force majeure,* suspending its contractual obligation to supply coal to its buyer under the fuel supply agreement. The parties' agreement designates the supplier as the buyer's sole supplier for a twenty year period wherein the supplier makes monthly deliveries to the buyer at a price set by a formula contained in the parties' agreement. In mid-2000, ten years into the agreement, the seller sent out a general notice to all of its customers, advising them of its complete inability to continue its coal-processing and shipping operations due to labor strife interfering with its ability to process and move coal to its loading port. The buyer made alternative arrangements for two subsequent shipments, asserting that it was an act of *force majeure,* relieving both parties of their obligation to perform. However, the supplier argued that the buyer acted prematurely in finding another supplier because after the labor strike, the supplier became ready, willing and able to make the shipment. Further, the supplier argued that if the strike continued, then the supplier had the right to nominate an alternative source to supply the buyer. Ultimately, the Court held that the

buyer did not have to assume the risk that a tightening market, caused by the scrambling of its' numerous coal customers to locate alternate sources, might lock out the buyer altogether if it did not cover quickly for the near term. However, the Court found that the buyer could not act as if the *force majeure* would never cease finding that the *force majeure* event was insufficient to excuse its contract obligations with respect to subsequent shipments.

- **Florida Example:** In *Gulf Power Co. v. Coalsales II, LLC*, 661 F.Supp.2d 1270 (N.D.Fla. Sept. 30, 2009), the Court analyzed under Florida law, whether the coal seller's nonperformance of delivery of coal was excused by the *force majeure* provision of its contact in light of the closure of the mine that provided the primary source of coal. The agreement between the parties identified three sources of coal to be supplied under the contract. Later amendments to the agreement limited the amount of coal from certain sources and the parties dispute whether the agreement, as amended, was a "sole source" agreement which required the supplier to supply the coal from only one specific source, the Galatia Mine. Thereafter, the supplier notified the buyer that Galatia Mine, the coal mine supplying the coal, was afflicted by adverse geological conditions causing supplier to not be able to make delivery of the tonnage requirements of coal, constituting a nonpermanent *force majeure* event. The Court found that there were adverse conditions at the Galatia Mine and that those conditions were not in the control of the supplier. However, the Court found that other mines were approved and available to the seller such that the nonperformance was not excused by the *force majeure* clause.

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