

Client Alert

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Will COVID-19 Terminate Your Contracts? A Step-by-Step Guide to Understanding Force Majeure Clauses During the Pandemic

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The COVID-19 pandemic is causing severe damage to the world economy. Starting new projects and commercial relationships will certainly be more difficult in the near- and medium-term future. However, will Japanese companies' current contracts also be affected?

As the last few weeks demonstrate, the answer to that question might be "yes." Recently, the major US retailer Mattress Firm and other global companies have invoked "force majeure" clauses in some of their critical contracts.

Baker McKenzie has recently published a comparative analysis relating to COVID-19 and force majeure (covering the laws of 28 jurisdictions).¹ However, as a first step, it is very useful to understand the basic terms (and meanings) of the force majeure clauses in your existing English-language contracts. These clauses are often densely worded and difficult to understand for internal legal and business teams.

Below, we suggest a simple, step-by-step approach for analyzing force majeure provisions in contracts governed by US or English law² that can be summarized as follows:

- If your contract does not have a force majeure clause, other contract doctrines (such as "impossibility" or "impracticability") may still allow contracts to be suspended or terminated for COVID-19-related reasons.
- Does your force majeure clause exclude payment? If not, one or both parties may be able to invoke force majeure to suspend or terminate payment obligations.
- Does your contract have an "open list" or "closed list" of force majeure events? If it has an open list, items not listed (such as epidemic or pandemic) may still qualify as force majeure. If it has a closed list (and pandemic, epidemic, etc. are not listed), it may still be possible to declare a COVID-19-related force majeure under listed items indirectly caused by COVID-19.
- Does your contract require (or allow) the seller or supplier to proportionally allocate shortfalls to all customers during a force majeure event? If this issue isn't expressly addressed, such

¹ For Baker McKenzie's global publication, please see "[International: COVID-19 - Force Majeure Comparative Table](#)".

² Please note that US contract law is a matter of state law, which means results (and rules for interpreting force majeure clauses) may differ under the law of each state. When we reference US law below, we are noting the "majority" position taken by commercially significant US states (such as New York and Delaware).



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proportional allocation may (depending on the wording of the contract as a whole) still be permissible.

- Does your contract contain force majeure notice deadlines and other reporting requirements? A failure to meet notice deadlines or other reporting requirements may restrict (or eliminate) a company's ability to successfully declare force majeure.
- Can your contract be terminated if a force majeure event continues for a long period of time? If your contract allows termination after X "consecutive" days of force majeure (but not termination after Y "cumulative" days in any period of Z days), later lockdowns related to secondary COVID-19 outbreaks may mean that a contract can only be suspended (and not terminated) due to force majeure.
- In an M&A context, if your transaction documents have a "material adverse effect" (MAE) termination right, the buyer may not be able to declare MAE due to COVID-19 if the definition of MAE specifically excludes events (recessions, etc.) that are affecting everyone.
- For risk management purposes, it may be helpful for companies to systematically review the force majeure clauses in key contracts (to check for the issues raised by this alert).

Does your contract have a force majeure clause?

Under Japanese law, force majeure is interpreted as a case of no fault on the part of the obligor. In other words, in a Japanese law-governed contract, parties may be able to invoke force majeure even if force majeure is not expressly stated in the contract. The US and England are very different. If force majeure is not expressly stated in a contract, the parties will not have any force majeure rights.

However, even if a US or English law-governed contract does not have a force majeure clause (or where it has a force majeure clause, but the requirements for force majeure are not met), it may still be possible to suspend performance under a contract (or terminate it) without breaching the contract. Please note that the items described below will probably not be available if your contract has a clause stating that all remedies in the contract are "exclusive." However, in the absence of an "exclusive remedy" clause, US and English courts will generally presume (in the absence of other compelling evidence) that stated contract remedies are "cumulative." In other words, in such cases parties will be able to exercise other remedies (not stated in the contract) available at law or equity.

Separate from force majeure, many US states have common law (i.e., court-created and not statutory) contract doctrines of "impossibility" and "impracticability." England has a similar doctrine of "frustration." In some cases, these doctrines may allow a party to terminate a contract without breach or liability.

Generally, impossibility means that there has been an event (the non-occurrence of which was assumed by both parties) that makes performance



under the contract literally impossible. For example, suppose two parties entered into a contract to sell an original painting. If the painting (a unique, one-of-a-kind item) is accidentally destroyed, performance under the contract is impossible — no amount of money or effort can change the situation.

Separately, impracticability means that performance has become so difficult or expensive that performance is "impractical." This is a fact-based determination, and US and English courts are generally very reluctant to suspend or terminate contracts based on impracticability or the fact that they have become more onerous since many parties might want to terminate contracts the moment they are slightly less profitable than expected.

Other items (such as the doctrine of "frustration of purpose," US state-adopted versions of the Uniform Commercial Code (UCC), or the United Nations Convention on Contracts for the international Sale of Goods) may also be applicable in specific situations.³

Please note that in comparison to relying on a well-written force majeure clause, it is generally more difficult to suspend or terminate a contract pursuant to "impossibility," "impracticability" or similar doctrines. However, parties to contracts without force majeure clauses (or contracts where the stated requirements for force majeure aren't met) should carefully consider whether an alternative is potentially available.

Does your force majeure clause exclude payment?

Many force majeure clauses specifically state that they do not apply to payment. In other words, neither party can use the force majeure clause (even if every other requirement in the clause is met) to avoid a payment obligation.

What happens if a force majeure clause does not specifically exclude payment? In that case, US and English courts may allow a party to use force majeure to temporarily suspend its payment obligations (if goods or services have already been received) or terminate payment obligations and the contract entirely (if not).

Does your force majeure clause have a "closed" or "open" list of force majeure events?

Many (or most) force majeure clauses will state a general (and abstract) definition of force majeure, which might be something like "any event or circumstance beyond the reasonable control of the party (and provided that such event or circumstance could not have been reasonably foreseen or prevented by the relevant party)." The clause might go on to say that force majeure "may (provided the above definition is satisfied) include the following events..." At that point, the clause will list typical force majeure items (e.g., wars, acts of God, etc.).

³ For an in-depth discussion of force majeure alternatives in the US, see ["No Force Majeure Clause? Other Potential Options to Excuse Contractual Performance Under US Law in the Face of COVID-19"](#).



This is an "open" list, which has two important consequences. First, items not specifically included in the list (e.g., epidemic or pandemic) may still be force majeure if the "general" definition is satisfied. Second, even items on the list may not qualify as force majeure if the "general" definition is not also satisfied. It is even possible (depending on the exact wording) that listed items are automatically force majeure, and anything unlisted may be force majeure if it meets the requirements of the general definition. For these reasons, the precise wording of the clause is extremely important.

In some cases, a force majeure clause may not include a "general" definition of force majeure. Instead, the clause will state that force majeure "shall consist" of a specified list of items. This is a "closed" list.

On a closed list, items not appearing on the list will not qualify as force majeure. Please note, however, that a COVID-19 force majeure may be possible even if a closed list does not include items like "pandemic," "epidemic," or "disease." First, depending on the jurisdiction, more general terms like "Act of God" may be interpreted to cover COVID-19. Second, companies should consider the indirect effects of COVID-19. For example, if a supplier can't realistically perform under a contract because the government orders a shutdown of factories, a party may be able to declare force majeure under a listed item (e.g., "government decrees of general applicability") even if pandemic, etc. is not listed.

Does your force majeure clause require a party to treat all customers equally?

Suppose that a supplier has three contracts with parties A, B and C (each for 25 units of a product — i.e., 75 units in total). Because of a force majeure event, the supplier only has 25 units in total. Could the seller give all 25 units to A, and invoke force majeure under B and C's contracts? Alternatively, could the Seller give 7 or 8 units to all three parties, and declare force majeure for the remaining portions under all three contracts?

This is an issue that often arises in certain types of contracts (especially commodity contracts, such as those for oil, gas, LNG, etc.). Typically, such commodity contracts will contain clauses requiring the supplier to proportionally allocate any force majeure shortfall among all of its customers. More rarely, a supplier might agree to fully supply a sufficiently important customer before any other customer. If there is a clause expressly addressing this issue, US and English courts will generally follow it as written.

If a force majeure clause does not expressly address this issue, it is not completely clear if US and English courts will allow a party to declare force majeure and proportionally allocate shortfalls among customers. Both US and English courts have issued conflicting decisions, but generally those courts will look for any hint (in the wording of the contract) of whether the parties acknowledge that other customers of the performing party are receiving the same product. If the buyer appears to acknowledge the existence of other seller or supplier customers, it is more likely that US and English courts will allow a seller or supplier to proportionally allocate force majeure shortfalls. Additionally, US and English courts may consider the normal practice in the relevant industry.



Does your force majeure clause contain notice requirements?

A typical force majeure clause might require a party claiming force majeure to do some or all of the following:

- report the existence of a force majeure event within X days;
- provide specific details about exactly how (and to what degree) the force majeure event impacts performance;
- provide an estimate as to when the force majeure event will end and when the party will resume performance; and/or
- use commercially reasonable efforts to mitigate or resolve the force majeure event and resume performance.

If these requirements are not followed, US and English courts may rule that the requirements for force majeure have not been met even if the underlying event is clearly force majeure in the abstract. Parties considering declaring force majeure (or responding to such a declaration) should pay especially careful attention to reporting deadlines.

Does your force majeure clause allow suspension and/or termination of the contract?

Often, force majeure clauses will state that a contract may be terminated if a force majeure event continues for X consecutive days. Some may also state that a contract may be terminated if there are Y cumulative days of force majeure within any Z day period.

If a contract has a "consecutive" termination clause (the first sentence above), but not a "cumulative" termination clause (the second sentence above), it is possible for a party declaring force majeure to avoid contract termination by resuming service for short periods.

This is potentially important in the COVID-19 context. For example, a COVID-19 lockdown could be in force for a certain time period (less than the "consecutive" termination period), and then lifted. The party invoking force majeure resumes performance, but declares force majeure again when there is a later lockdown and wave of COVID-19. In that case, the party not declaring force majeure will not be able to terminate based on "cumulative" force majeure unless the contract specifically allows it.

Further, when reading and drafting the termination clause, pay close attention to whether a termination right is given to: (i) the party not invoking force majeure (only), or (ii) both parties to the contract. Option (i) is better for the party less likely to invoke force majeure (e.g., a party who only has payment obligations). If the party declaring force majeure also has a termination right, that party may be more likely to declare force majeure in the first place.

Finally, what happens if your contract contains a force majeure clause, but that clause does not mention termination at all? In that case, force majeure will allow



the declaring party to suspend performance, but US and English courts will probably not conclude that there is an implied, automatic termination right for the party not declaring force majeure. It is theoretically possible under other common law contract doctrines such as good faith and fair dealing, "frustration of purpose" or the like that a US or English court would, after a long enough force majeure delay period, conclude that the party not declaring force majeure may terminate the contract. However, the outcome in that case is very uncertain and hard to predict. From a risk management perspective, it is much better to include a clear termination clause.

Does your deal's "material adverse effect" clause exclude events affecting everyone?

M&A documentation (e.g., share purchase agreements) do not usually contain "force majeure" clauses. However, when signing and closing are not simultaneous, they do sometimes contain "Material Adverse Effect" (MAE) clauses. In that case, a party (usually the buyer) will have the right to terminate the deal without liability prior to closing if the target and/or the other party is subject to an MAE (as defined in the agreement).

Unlike force majeure clauses, MAE clauses do not typically contain a list of items that "do" constitute MAE; there is usually a general and abstract definition only. However, MAE clauses often contain a list of items that are specifically excluded from the definition of MAE. Sometimes, these exclusions state that MAE will not apply if other companies in the target's market or industry are suffering a proportionally similar negative effect. Alternatively, or in addition, an MAE clause might exclude national or global economic recessions that negatively affect the target.

For pending and future deals, any MAE condition should be carefully checked. If the general definition of MAE does not contain any exclusions (or any relevant "industry/national/global effect" exclusions), it may be possible to declare MAE if COVID-19 is materially affecting the target. If the MAE clause contains exclusions similar to the above, it will probably be more difficult to declare MAE and terminate the deal. As always, the exact wording of the MAE definition is very important.

Final thoughts and practical tips

- Successfully declaring force majeure is very dependent on both the facts of the relevant situation and the exact wording of the force majeure clause.

For this reason, when analyzing your force majeure clauses, never assume after a quick reading that a particular situation is "automatically" force majeure or could "never" be force majeure. We recommend carefully reviewing the facts and the contract with your internal legal team and outside counsel.

- For Japanese companies (regardless of whether they are considering declaring force majeure or believe that a counterparty may do so), it may be useful to perform a systematic review of the force majeure



clauses in key contracts (for instance, in a chart format and addressing relevant issues raised in this alert).

This will help your company identify high-risk contracts (in a COVID-19 context), and provide a firm basis to negotiate with counterparties to amend COVID-19-affected agreements. Amendment of affected agreements will often be preferable to declaring force majeure, since a voluntary agreement preserves the commercial relationship and does not create litigation risk.

We will continue to monitor current events in this area and provide further updates as necessary.