

Contracts Are Binding—In Good Times, and Bad? Contractual Impossibility, Material Adverse Change Clauses and Adequate Assurances During Economic Crisis

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The global financial crisis has placed many long-term contractual obligations under strain, leading some parties to seek relief from the difficulty of performing under agreements made before the broad economic downturn. Donald Trump made headlines by seeking to delay payment of loans on a luxury Chicago high-rise when sales of condo units slowed during the recession, claiming force majeure. Bank of America executives have been at the center of legal investigations and Congressional hearings into their possible attempt to back out of a deal to acquire Merrill Lynch, which recorded billions of dollars in losses at the end of 2008, relying on a material adverse change (“MAC”) clause in the agreement. Alan Greenspan, testifying before Congress in October 2008, likened the crisis to a “once-in-a-century credit tsunami”—suggesting similarities with natural “Acts of God” which in some circumstances provide defenses to contractual performance.¹

This article discusses impossibility, material adverse effects clauses, and demands for adequate assurances, and examines claims arising from these concepts in some recent high-profile commercial cases, some decided under the Uniform Commercial Code (“U.C.C.”) and others under common law. How have clauses dealing with such issues in existing contracts fared under attack?

I. Force Majeure and Impossibility

The doctrine of impossibility allows a party to suspend or avoid performance when a supervening event beyond its control makes performance of the contract no longer capable of being performed.² As a general matter, events giving rise to claims of force majeure must not be foreseeable at the time of contract.³ Additionally, parties may craft their own definitions of force majeure events which excuse non-performance of contractual obligations.

¹Sharon Otterman, *Volatile Till The Close, Markets End On Upswing*, N.Y. Times, October 24, 2008, at B6.

²17A Am. Jur. 2d *Contracts* § 655 (2010) (“[S]upervening impossibility exists when the subject matter of the contract for which the parties bargained is no longer in existence or is no longer capable of being performed due to an unforeseen, supervening act for which the promisor is not responsible.”) (citations omitted).

³17A Am. Jur. 2d *Contracts* § 659 (2010) (“The prevailing view is that the defense is available only when there was an unanticipated or unforeseeable circumstance that made performance impossible or impracticable.”) (citations omitted).

A. Basic Principles

In the United States, impossibility or impracticability provide widely recognized defenses excusing a party's failure to perform under a contract even when no express contractual clause applies. Generally, such defenses are available only when an unforeseen event beyond the control of either party causes the destruction of the subject matter of the contract, or renders performance so difficult as to be commercially impracticable.⁴ The doctrine, recognized both as a matter of the common law⁵ and under the U.C.C., is narrowly applied. The U.C.C. recognizes a defense of impracticability at Section 2-615:

Delay in delivery or non-delivery in whole or in part by a seller . . . is not in breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid.⁶

The Official Comments to the U.C.C. note that neither “increased cost alone” nor a “rise or a collapse in the market in itself” are cause to invoke an impracticability defense, as the risk of such events are expected to be negotiated by the parties.⁷ However, the comments provide that impracticability may arise from shortages of raw materials or supplies resulting from events including “war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like”—that is, severe external events which cause a “marked increase” in costs or prevent the seller from obtaining necessary supplies entirely.⁸

Although impossibility provides a defense in the absence of a contractual provision in many states, parties frequently negotiate contractual clauses which specify events under

⁴See Am. Jur. 2d, *Contracts* § 656.

⁵See Restatement 2d, *Contracts* § 261 (“Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or circumstances indicate the contrary.”).

⁶U.C.C. § 2-615 (2004).

⁷U.C.C. § 2-615 cmt. 4 (2004).

⁸*Id.*

which non-performance will be excused. Typically, parties agree to suspend performance until the event no longer prevents performance. Parties may negotiate to receive some payments during the suspension; they may also negotiate the right to terminate performance altogether if the force majeure event continues beyond a stated period.

Disputes typically arise over whether a particular event falls within the ambit of a force majeure clause. A force majeure clause will typically list specific events, such as riots, fires and Acts of God. In addition, contracts may include a broader “catch-all” clause. Courts often apply the principle of *ejusdem generis* to interpret these definitions, by reading the catch-all clause narrowly to encompass only events similar to those specifically described. Thus, a contract providing that performance may be excused as impossible in the event of fires, floods and hurricanes may be held to include a blizzard but not a labor strike.

The law generally requires some element of proximate cause between the force majeure event and the failure to perform. Where a force majeure event does not render performance impossible, but rather creates conditions which in turn render performance economically burdensome, the force majeure usually is not found to be the proximate cause of non-performance. For example, courts may embrace the position that the economic infeasibility created under some contracts by the 9/11 attacks is not a sufficient proximate cause to constitute a force majeure event.

B. Select U.S. Jurisdictions

Defenses of impossibility and impracticability may be applied with slight variations under different state laws. Below, we consider the application of the doctrine in recent significant commercial cases in select jurisdictions.

● ***New York***

Under New York law, the common law defense of impossibility applies only to the destruction of the means of performance by an Act of God, by Vis Major (i.e., an overwhelming natural force), or by law, and has limited scope. Courts generally will not apply the doctrine where the impossibility could have been foreseen or guarded against in the contract. In addition, events that would merely cause one party's per-

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formance to put it at a financial disadvantage generally do not permit an impossibility defense.⁹

Generally, New York courts treat broad economic conditions as akin to changed circumstances that make performance financially burdensome. In an illustrative case, the state's high court held that a crisis in the liability insurance industry did not make it impossible for a commercial lessee to maintain a \$1 million policy as required under its lease agreement.¹⁰ In *Kel Kim*, the court held that the possible unavailability of insurance coverage did not destroy the subject matter of the contract or the means of performance, and further that an inability to maintain coverage could have been foreseen at the time of contract; the court accordingly found that plaintiff was not excused from performance on common law impossibility grounds.¹¹ The court also declined to excuse performance on the basis of a contractual clause which set forth events that would constitute force majeure, including "labor disputes, inability to procure materials, failure of utility service, restrictive governmental laws or regulations, riots, insurrection, war, adverse weather, Acts of God, or other similar causes beyond the control of such party . . ."¹² An inability to procure insurance was not specifically included in this clause, and the court construed the catch-all provision as referring to other traditional force majeure events similar to those enumerated, which would prevent daily commercial operations.¹³ Similarly, in a decision under New York law involving the obligations of broadcasting companies to repay a credit agreement, a

⁹*See, e.g.*, 407 East 61st Garage, Inc. v. Savoy Fifth Ave. Corp., 23 N.Y.2d 275, 281, 296 N.Y.S.2d 338, 344, 244 N.E.2d 37 (1968) ("[W]here impossibility or difficulty of performance is occasioned only by financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy, performance of a contract is not excused.") (citations omitted).

¹⁰*Kel Kim Corp. v. Central Markets, Inc.*, 70 N.Y.2d 900, 901–2, 524 N.Y.S.2d 384, 385, 519 N.E.2d 295 (1987).

¹¹*Kel Kim Corp. v. Central Markets, Inc.*, at 902, 524 N.Y.S.2d at 385.

¹²*Kel Kim Corp. v. Central Markets, Inc.*, at 902 n.*, 524 N.Y.S.2d at 385 n.*.

¹³*Kel Kim Corp. v. Central Markets, Inc.*, at 903, 524 N.Y.S.2d at 386.

federal district court held that a broad economic downturn did not excuse the companies' failure to perform.¹⁴

However, in notable contrast, a recent decision under New York common law by a federal district court in Indiana held that the crisis in the financial markets in 2008 *did* amount to an unforeseeable event permitting a defense based on "temporary commercial impracticability."¹⁵ In the context of a motion for a preliminary injunction, the court found reasonable probability existed that plaintiff Hoosier Electric could succeed on its argument that turmoil in credit markets had prevented it from fulfilling contractual obligations. Under a sale in-lease out ("SILO") agreement, the plaintiff had sixty days to find a qualified replacement credit default swap provider following a ratings downgrade to an existing swap partner in June 2008. After extensions to find and negotiate possible lenders, the plaintiff's board approved a term sheet for a deal with Berkshire Hathaway. Because Berkshire required 90 days between signing and closing, however, the defendant John Hancock entities—parties to the SILO agreement—declared plaintiff in default and sought termination payments. The court held that the crisis was an "unprecedented" event that was larger than a "mere economic downturn," had not been predicted by the experts, and was not foreseeable at the time of contract six years prior:

[Plaintiff] has come forward with evidence indicating that the obstacles it faced were not specific to [the swap partner] but were the product of the credit crisis that effectively but temporarily froze the market for comparable credit products at *any price*. Those effects were not anticipated and could not have been guarded against.¹⁶

The court emphasized that the additional time requested by

¹⁴Barclays Bus. Credit, Inc. v. Inter Urban Broad. of Cincinnati, Inc., No. 90 Civ. 2272 (MJL), 1991 WL 258751, at *8 (S.D.N.Y. Nov. 27, 1991) ("[I]t appears that these events [purportedly rendering performance impossible] may be the loss of income that the Group sustained due to the slowdown in the New Orleans economy. This defense must fail if economic hardship is its basis.") (record citation omitted).

¹⁵Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., 588 F. Supp. 2d 919, 933 (S.D. Ind. 2008), *aff'd* but criticized, 582 F.3d 721 (7th Cir. 2009).

¹⁶588 F. Supp. 2d at 932 (emphasis in original). Notably, the *Hoosier* decision also quoted Alan Greenspan's "tsunami" testimony as further indication that the crisis was the cause of the plaintiff's inability to find a new swap partner and that the crisis had not been foreseeable, since it

plaintiff—90 days—was “reasonable” in light of the market difficulties, the complexity of the transaction, and the likelihood of completing the Berkshire Hathaway deal, and held that these amounted to a reasonable likelihood of success of arguing “temporary commercial impracticability.”¹⁷

On appeal, the Seventh Circuit affirmed the order granting a preliminary injunction, but sought to rein in the scope of the plaintiff’s defense to liability based on the financial crisis.¹⁸ The appellate decision criticized the lower court’s application of a “temporary commercial impracticability” doctrine, which, it found, had never been recognized by New York law.¹⁹ Further, it suggested that no impossibility defense would be available if the plaintiff’s contractual obligation was characterized as an option—that is, if plaintiff had the choice of either finding a new swap provider or paying termination fees upon a downgrade of its swap partner.²⁰ However, the court held that an impossibility defense could be asserted if the plaintiff had a contractual *duty* to find better surety, such that:

(a) all parties to the [SILO] transaction assumed, when they negotiated the terms, that it would be possible to find *some* other intermediary with adequate credit standing, and (b) as a result of a financial crisis, no such intermediary existed in late 2008, no matter how much [plaintiff] offered to post in liquid assets to secure its obligations.²¹

Finding factual questions as to whether the contractual obligation was an option or a duty, as to whether the extent of the financial crisis was truly unforeseeable at the time of

“was not anticipated by the most senior economists in the country.” *Id.* at 924 (“Based on the limited information before the court, this year’s credit ‘tsunami’ appears to have been the primary reason that Ambac’s credit rating fell. The credit crisis also appears to have made it impossible—or nearly impossible—for Hoosier Energy to find a substitute for Ambac with a sufficient rating, on time, and at any price.”).

¹⁷Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., at 933.

¹⁸Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., 582 F.3d 721, 730 (7th Cir. 2009).

¹⁹Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., at 728–29.

²⁰Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., at 729.

²¹Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., at 729 (emphasis in original).

contract, and as to whether plaintiff could have found a suitable swap partner, the Seventh Circuit affirmed the preliminary injunction under a deferential appellate standard of review.²² The court also noted that the extended delay in enforcing plaintiff's obligations weighed against this holding, and suggested that if plaintiff failed to conclude a new swap transaction by the end of 2009, the injunctive relief should be lifted.²³

Similarly, in a suit filed in November 2008, with lackluster sales of apartments at his Trump International Hotel and Tower in Chicago, Donald Trump argued that the global economic crisis constituted a Force Majeure Event as defined in a \$330 million construction loan agreement, and sought an injunction postponing the maturity date of the loan agreement until a reasonable time after the conclusion of the crisis.²⁴ Under the agreement, Force Majeure Events must "actually result in a delay of the development or construction of the Project," and were defined as:

(i) acts of declared or undeclared war by a foreign enemy or terrorist acts; (ii) riots, civil commotion or insurrection; (iii) casualty or condemnation; (iv) fire, floods, hurricanes or other casualty; (v) earthquakes; (vi) acts of God; (vii) governmental preemption in the case of a national emergency; (viii) unavailability of labor or materials to the extent not within the reasonable control of Borrower or any Trade Contractor; (ix) strikes, lockouts or other labor trouble; (x) the suspension of governmental operations, which suspension affects real estate development in the City of Chicago generally and is not particular to Borrower or the Project; and (xi) any other event or circumstance not within the reasonable control of Borrower or any Trade Contractor[.]

Trump argued that financial crisis fell within the catch-all provision, in subsection (xi). If the case goes forward, Trump may have difficulty seeking an injunction in light of the *ejusdem generis* principle of contract interpretation. None of the events enumerated in subsections (i)-(x) appear to suggest that the parties also contemplated excusing non-performance in the case of a market downturn; rather, they

²²Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., at 729–30.

²³Hoosier Energy Rural Elec. Co-op., Inc. v. John Hancock Life Ins. Co., at 730.

²⁴Donald J. Trump v. Deutsche Bank Trust Co. Americas, No. 26841/08 (N.Y. Sup. Ct. Queens Co.).

appear to be primarily events outside the real estate or finance markets that would make it difficult to continue with construction or to sell units.

● *Delaware*

In Delaware, courts have recognized that under common law contracts can be discharged as impracticable where (1) the party establishes the occurrence of an event, the non-occurrence of which was a basic assumption of the contract; (2) continued performance is not commercially practicable; and (3) the party claiming discharge shows that it did not expressly or impliedly agree to performance in spite of impracticability.

The Delaware Court of Chancery has applied the doctrine of commercial impracticability in a declaratory judgment action involving a municipal parking authority's attempt to terminate its obligations under a lease agreement with a commercial tenant of a parking garage.²⁵ There, following the execution of the five-year lease with renewal options, the plaintiff learned of structural damage requiring repair that would shut down the garage for a year, creating a large cash flow loss. Arguing that it should be permitted to demolish the facility instead of financing construction of a new garage, the plaintiff sought a ruling that continuing the tenancy would be commercially impracticable. The court denied a motion to dismiss, although it noted that a clause in the lease identified damage from "fire, explosion or any other casualty . . ." as grounds for non-performance.²⁶ Thus, questions of fact existed as to whether structural defects fell within the scope of the force majeure clause, and also whether the plaintiff had agreed to perform despite a discovery of such flaws. The court also held that commercial impracticability had been alleged, where plaintiffs asserted that the one-year shutdown would cause a \$400,000 loss in net cash flow, and that the defendant tenant provided less than 3% of the annual revenues from running the garage.²⁷

In a case filed in the Court of Chancery in January 2009, Dow Chemicals argued that its acquisition of another chemical company was both commercially impracticable and

²⁵J & G Assocs. v. Ritz Camera Ctrs., Inc., Civ. A. No. 9811, 1989 WL 115216 (Del. Ch. Oct. 3, 1989).

²⁶J & G Assocs. v. Ritz Camera Ctrs., Inc., at *4–5.

²⁷J & G Assocs. v. Ritz Camera Ctrs., Inc., at *5.

impossible to perform in light of certain consequences of the financial crisis.²⁸ Dow had intended to finance the acquisition in part with \$9 billion it would have received in connection with the closing of a joint venture with the Kuwaiti national petrochemical company; however, on December 28, 2008, Kuwait's Supreme Petroleum Council rescinded its approval of the deal. Shortly after, Dow allegedly failed to timely close a merger and plaintiff Rohm and Haas sued, seeking specific performance under the merger agreement. Dow responded that performance of the agreement had been rendered impossible in light of economic events, which included an "accelerating downturn" in the global economy and financial markets; an "unprecedented falloff" in Dow's earnings and demand during the latter half of 2008 (including a 30% fall in sales between October and December); difficulties in negotiating a refinancing of its bridge loan with a nineteen-bank consortium (including a lead lender, Merrill Lynch, which had ceased to exist as a standalone company); "dramatic changes" in Dow's ability to comply with the debt-to-EBITDA ratio covenant under the expected bridge loan; and pronouncements by the ratings agencies that Dow's credit rating would be significantly cut (possibly to below investment grade) if the merger was consummated as initially contemplated. However, the parties announced a settlement with Dow paying a reduced equivalent price per share on March 9, 2009, before the issue was determined by the court.

● **Texas**

Under Texas law, common law force majeure doctrines are disfavored and courts generally decline to read implicit requirements into force majeure clauses. However, Texas law recognizes the doctrine of impossibility in at least some instances.²⁹

²⁸Rohm and Haas Co. v. The Dow Chem. Co, et al., C.A. No. 4309-CC (Del. Ch.).

²⁹For instance, the Texas Supreme Court has applied the doctrine of impossibility as set forth in the Restatement 2D, Contracts § 261, in the context of an intervening change in laws. *See Centex Corp. v. Dalton*, 840 S.W.2d 952 (Tex. 1992) (excusing corporation's failure to pay a contractual finder's fee in connection with an acquisition of a thrift when federal bank regulators prohibited the payment, regardless of whether the regulators' prohibition was foreseeable).

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In *Sun Operating Limited Partnership v. Holt*,³⁰ a state appellate court illustrated the strict approach under Texas law. There, the trial court had instructed the jury that lessors of an oil field were required to exercise due diligence to avoid or overcome a force majeure event, when no such requirement was expressly set forth in the contract. On appeal, this instruction was held to be error: “Force majeure, [sic] is now little more than a descriptive phrase without much inherent substance. Indeed, its scope and application, for the most part, is utterly dependent upon the terms of the contract in which it appears.”³¹

C. Conclusion

Parties may find claims of force majeure or impossibility to be attractive in the face of general economic difficulties, as recent high-profile cases suggest. However, the doctrines traditionally have been strictly applied, and courts appear likely to continue to emphasize the core issues such as destruction of the means of performance, lack of foreseeability, and strict contract interpretation which may prove difficult to apply to commercial transactions between sophisticated parties on the grounds of economic crisis.

II. Material Adverse Change / Effect Clauses

Where supervening events do not rise to the level of force majeure or impossibility, parties may seek relief on other grounds which account for unexpected changes in fundamental conditions of the contract. In the U.S., material adverse change (“MAC”) or material adverse effect (“MAE”) clauses are familiar elements of merger agreements, and have become the subject of increasing attention and negotiation in recent decades. By specifying future scenarios in which either or both of the parties do not want to continue the deal as negotiated, they can provide means to force another party to renegotiate or to break up the transaction entirely. Because MAC clauses are created by contract, their scope is defined by the parties to an agreement. Generally, buyers seek broad MAC clauses and sellers prefer narrow clauses that make the deal more likely to close.

MAC clauses are perhaps best understood as tools used to allocate risk between a purchaser and seller during an

³⁰*Sun Operating Ltd. Partnership v. Holt*, 984 S.W.2d 277, 142 O.G.R. 392 (Tex. App. Amarillo 1998).

³¹*Sun Operating Ltd. Partnership v. Holt*, at 283.

interim period between the initial signing of an agreement and the closing. Different theories are useful in explaining how parties attempt to allocate that risk. Under a “symmetry” theory, for instance, the MAC clause is a contractual readjustment of risk that may not be allocated symmetrically between buyer and seller. Under an “investment” theory, buyers rely on MAC clauses to force the seller to continue to preserve going concern value during the interim period. A “renegotiation leverage” theory treats the MAC as allocating leverage between the parties in potential renegotiations.

The form of the standard MAC clause has evolved in recent years as the provisions have taken on increased prominence in merger transactions. Traditionally, MAC clauses were simple provisions used to account for unforeseen risks under a broad, standard-based system of interpretation. Parties relied on vague language to define a MAC event, such as:

“Material adverse change” means any material adverse change in the business, results of operations, assets, liabilities, or financial results of operations of the Seller and its subsidiaries, as determined from the perspective of a reasonable person.

The modern MAC clause, by contrast, is heavily negotiated and includes detailed provisions defining a MAC event or specifying events which do not fall within the ambit of the clause, which are interpreted under a rule-based system. Generally they are seen more as an excuse for a party’s non-performance than as a tool to obtain leverage. Modern MAC clauses may in fact increase the closing risk of a given transaction by creating uncertainty.

Parties drafting MAC clauses attempt to craft language tailored to their own concerns and the peculiar concerns of the transaction. In particular, the definition of “materiality” in the MAC clause may be the subject of debate, as parties attempt to define it as either a monetary or quantity amount. Another key point in negotiations is whether the MAC clause contains forward-looking language such as “reasonably expected to have a material adverse effect.” Such language will likely be a source of litigation if problems with the transaction arise, and may even increase the likelihood of litigation; it is usually sought by the purchaser as protection against events that will cause a decrease in the target’s short-term earnings. Sellers, on the other hand, usually negotiate for the exclusion of specified events from the ambit of the MAC clause, including failures to obtain governmental approvals, regulatory changes affecting the seller’s industry,

events affecting the US economy, terrorist attacks, and changes in GAAP.

It is noteworthy that courts in the United Kingdom take a more skeptical approach to MAC clauses than in the U.S. MAC clauses in transactions in the UK between private companies are matters of contract, as in the U.S. However, MAC clauses involving a company traded publicly on a UK market are regulated by the UK's Takeover Panel.³² Notably, such MAC clauses may not contain any exceptions and are generally standardized,³³ constraining the ability of counsel to customize the transaction to factors peculiar to the industry or the parties involved.

A. Select U.S. Jurisdictions

Below, we discuss several notable transactions in which MAC clauses were invoked in the context of economic downturns.

● *New York*

In a prominent case arising from the merger of two large food distributors, a Delaware court ruled that, under a merger agreement governed by New York law, a temporary drop in earnings did not constitute a materially adverse effect.³⁴ The agreement defined an MAE as, in relevant part:

any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole . . .³⁵

The acquirer, Tyson, argued that the MAE clause was triggered when the target's earnings dropped 61% in the three quarters following the signing of the merger agreement and when the target announced a \$60 million impairment charge to a subsidiary. The court rejected this argument. Notably, the court found that under New York law, buyers were required to make a "strong showing" that the target had suf-

³²See Companies Act, 2006, c. 46, §§ 942-43 (UK).

³³See The Panel on Takeovers and Mergers, The City Code on Takeovers and Mergers, Rule 13 (2009), <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf> (last visited April 7, 2010).

³⁴In re IBP, Inc. Shareholders Litigation, 789 A.2d 14 (Del. Ch. 2001).

³⁵In re IBP, Inc. Shareholders Litigation, at 65 (record citation omitted).

ferred an MAE; because merger agreements are heavily negotiated, MAE clauses should only protect acquirers from “unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.”³⁶ Thus, materiality should be determined from the “longer-term perspective of a reasonable acquiror.”³⁷ In the *IBP* merger, the court emphasized that the target operated in a cyclical industry, and that the short-term fall in earnings was neither out of line with its historical performance nor a sign that the target would necessarily fail to provide higher earnings in the future.³⁸ Moreover, the subsidiary that suffered the impairment charge represented a “tiny fraction” of the target’s total business.³⁹ The *IBP* court contrasted the merger with an earlier case in a New York district court where a party successfully invoked a MAC clause following the target airline’s 40% decline in bookings over a three-month period.⁴⁰ That case, the *IBP* court noted, occurred in the context of a corporate bankruptcy, and so the deterioration of the debtor’s business performance over that period would be material to the financing party.⁴¹

In a recent case before a New York court, a manufacturer in Chapter 11 proceedings obtained commitment letters in October 2007 from three banks to provide financing for the company’s reorganization plan.⁴² Several months later, the banks argued they should be released from the commitment on the grounds that the syndication market had dried up, based on the downturn in the finance markets. Following negotiations, however, the banks provided loans on new terms without a court interpretation of the MAC clause.

● *Delaware*

Delaware courts follow the approach in the *IBP* case, which was decided by a Delaware court applying New York law. Thus, a MAC will generally not be found to have oc-

³⁶In re *IBP, Inc. Shareholders Litigation*, at 68.

³⁷In re *IBP, Inc. Shareholders Litigation*, at 68.

³⁸In re *IBP, Inc. Shareholders Litigation*, at 70–71.

³⁹In re *IBP, Inc. Shareholders Litigation*, at 70.

⁴⁰*Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438, 493 (S.D. N.Y. 1994).

⁴¹*IBP*, 789 A.2d at 68 n.154.

⁴²*Solutia Inc. v. Citigroup Global Markets Inc.*, No. 08-01057-pcb (Bankr. S.D.N.Y.).

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curred unless the events giving rise to it were unforeseen, present a substantial threat, and are durationally significant.

For instance, in a case involving mass toxic tort suits against a target oil company, the Delaware Chancery Court held that neither the costs of defending such litigation nor the risk of an adverse judgment presented a materially adverse effect to the target under a merger agreement.⁴³ The court noted that the parties' contract, negotiated after the *IBP* decision, contained a relatively broad MAE clause and held that the parties had placed the burden on the acquiring party of demonstrating that any litigation would have an MAE.⁴⁴ The acquirer failed to provide evidence that could demonstrate the likelihood that the mass tort litigation's outcome could have an MAE; nor did the acquirer establish that an estimated \$15 to \$20 million in legal fees to defend the suit would reasonably be expected to have an MAE, given the target's enterprise value.⁴⁵ Accordingly, the acquirer failed to meet the burden of showing that the potential outcome or defense costs of the mass tort litigation would "reasonably be expected" to have an MAE.⁴⁶

In a recent decision issued in the midst of the current financial crisis, the Chancery Court declined to excuse an acquirer's duty to perform under a merger agreement on the basis of a purported MAE.⁴⁷ The acquirer argued that the target corporation had suffered an MAE when (1) its pretax earnings fell by approximately 20% on a year-over-year basis with its forecasted future earnings projected to drop further; (2) its net debt increased by approximately 5%; and (3) two of the target's divisions, comprising approximately 25% of its earnings, faced short-term difficulties caused by temporary restructuring costs and macroeconomic conditions. The court, however, held that these declines were not material in light of its historic earnings or the earnings projected during negotiations, and that the target's total debt was also in line

⁴³Frontier Oil Corp. v. Holly Corp., No. Civ. A. 20502, 2005 WL 1039027, at *37 (Del. Ch. Apr. 29, 2005).

⁴⁴Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027, at **33–34.

⁴⁵Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027, at **35–37.

⁴⁶Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027, at *37.

⁴⁷Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008).

with the acquirer's deal models.⁴⁸ Further, the troubles at the target's subsidiaries were cyclical in nature, affecting the entire industry, and did not materially impair the target corporation as a whole.⁴⁹ Notably, the *Hexion* court suggested *in dicta* that the durational requirements of the MAE case law disfavored claims that a fall in earnings excused an acquirer's obligation to close: "Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence."⁵⁰

● **Tennessee**

A recent merger case in Tennessee involved the assertion that an MAE clause was triggered by corporate earnings in 2007 that were the lowest in ten years.⁵¹ In that case, the target of a \$1.5 billion merger sued for specific performance when the acquirer attempted to avoid its obligations after the target's shareholders approved the transaction. The court held that the MAE clause did not apply because the earnings decline fell within a carve-out for excluding general economic conditions; the target's losses were driven by higher consumer prices and debt loads and troubles relating to housing and mortgage issues.

Had the declines not been related to the general economy, however, the court stated *in dicta* that the target's losses would have amounted to an MAE. Although the losses had taken place over a matter of months, even subsequent improved performance would be insufficient to prevent 2007 from being one of the worst years in the company's ten-year performance history. Accordingly, because in the context of the merger agreement this period of losses represented a durationally significant period of time, the court noted that the *IBP* requirement was met.

B. Conclusion

Courts interpreting MAC clauses are likely to look to the *IBP* factors as persuasive. In particular, the question of durational significance will make it difficult for parties to claim a MAC on the basis of a broad market downturn,

⁴⁸Hexion Specialty Chemicals, Inc. v. Huntsman Corp., at 743–44.

⁴⁹Hexion Specialty Chemicals, Inc. v. Huntsman Corp., at 745–46.

⁵⁰Hexion Specialty Chemicals, Inc. v. Huntsman Corp., at 738.

⁵¹Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).

where the contracts do not expressly preclude a MAC based on general economic conditions.

III. Adequate Assurances

The doctrine of adequate assurances protects a party who has reasonable concerns of the other contracting party's ability to perform. The doctrine was first adopted in U.C.C. Article 2 (sale of goods) in 1978, but courts have been expanding its application to the common law more broadly. U.C.C. Section 2-609(1) provides:

When reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of due performance and until he receives such assurance may, if commercially reasonable, suspend any performance for which he has not already received the agreed return.⁵²

As the doctrine provides another avenue for contractual parties to explore remedies in the event of drastically changed circumstances, we briefly discuss the concept below and provide representative areas of law in which it has been applied.

A. Application

A party must have "reasonable grounds" for insecurity. Courts generally require a showing of insecurity based on a payment delay or on general economic or industry conditions. However, the analysis is heavily factual and depends on the expectations of the parties to a given transaction. For instance, in one notable case, a federal district court found questions of fact and remanded to Bankruptcy Court to determine whether the plaintiff had had reasonable grounds to seek assurance upon a downgrade to the defendant's credit rating, even where the two entities were parties to a power pool agreement which specifically provided that a credit rating downgrade "may trigger" questions as the party's financial security.⁵³ In particular, the *EPMI* court looked to the defendant's allegations that it had sufficient assets to remain a viable entity following the downgrade, and that

⁵²U.C.C. § 2-609(1) (2003).

⁵³*See, e.g.,* Enron Power Marketing, Inc. v. Nevada Power Co., 55 U.C.C. Rep. Serv. 2d 31 (S.D. N.Y. 2004), opinion supplemented, 2004 WL 3015256 (S.D. N.Y. 2004).

state regulators had previously determined the defendant had sufficient cash flow.⁵⁴

If reasonable grounds for insecurity do exist, a party may make a demand for adequate assurance of due performance. If the assurance is not provided, the party that sought assurance may suspend performance for any portion of the contract that is not paid for. Sufficient forms of assurance are also factual determinations, but may include escrow of funds,⁵⁵ letters of credit,⁵⁶ or accelerated or advance payments.⁵⁷

B. Expansion of Doctrine Outside the Sale of Goods

In recent years, U.S. courts have found that parties have the right to seek adequate assurances as a matter of common law in some circumstances where the dispute was not over the sale of goods. For example:

- In *Mears, Inc. v. Nat'l Basic Sensors, Inc.*,⁵⁸ the Pennsylvania Supreme Court held that an insurance company was required to give the insured “reasonable assurances” of coverage if the insured requests them.
- In *Patel v. Telerent Leasing Corp.*,⁵⁹ the Mississippi Supreme Court observed that the doctrine of adequate assurances has been extended to leasing transactions in Mississippi.

⁵⁴Frontier Oil Corp. v. Holly Corp., 2004 WL 2290486, at *3.

⁵⁵See, e.g., McNeal v. Lebel, 157 N.H. 458, 953 A.2d 396 (2008).

⁵⁶See, e.g., Creusot-Loire Intern., Inc. v. Coppus Engineering Corp., 585 F. Supp. 45, 50, 39 U.C.C. Rep. Serv. 186 (S.D. N.Y. 1983) (“[T]he assurances later sought by plaintiff—an extension of contractual guarantee and the posting of a letter of credit—were not unreasonable in light of the circumstances.”); see also Precision Master, Inc. v. Mold Masters Co., Nos. 268501, 268938, 2007 WL 2012807, at *4 (Mich. Ct. App. July 12, 2007) (holding that plaintiff’s demands of payment c.o.d. and interest on late payments was improper “unilateral attempt to alter” contract, and that defendant’s offer to provide letter of credit was sufficient assurance of performance).

⁵⁷See, e.g., Brisbin v. Superior Valve Co., 398 F.3d 279, 287–88, 56 U.C.C. Rep. Serv. 2d 152 (3d Cir. 2005) (holding that supplier’s request for immediate payment as assurance was appropriate where defendant manufacturer’s delays in conducting test run raised doubts about defendant’s “commitment to the projects”).

⁵⁸Mears, Inc. v. Nat'l Basic Sensors, Inc., 507 A.2d 32, 37–38 (Pa. 1986).

⁵⁹Patel v. Telerent Leasing Corp., 574 So.2d 3, 7 (Miss. 1990).

CONTRACTS ARE BINDING—IN GOOD TIMES, AND BAD?

- In *Drinkwater v. Patten Realty Corp.*,⁶⁰ the Maine Supreme Judicial Court held that the doctrine of adequate assurances in a dispute over a contract for the sale of real property.
- In *Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp.*,⁶¹ New York's highest court ruled that the doctrine "should apply to the type of long-term commercial contract between corporate entities entered into by Norcon and Niagara Mohawk here, which is complex and not reasonably susceptible of all security features being anticipated, bargained for and incorporated in the original contract."⁶²
- In *Spring Creek Holding Co. v. Shinnihon U.S.A. Co., Ltd.*,⁶³ a New Jersey appellate court found: "Accordingly, the modern view does not limit anticipatory repudiation to cases of express and unequivocal repudiation of a contract. Instead, anticipatory repudiation includes cases in which reasonable grounds support the obligee's *belief* that the obligor will breach the contract."

IV. International Considerations

Parties to contracts governed by international or foreign laws should be aware of the ways in which these principles have been adopted internationally. In general, foreign jurisdictions or international standards recognize *force majeure* for impossibility situations (where the remedy is suspension or termination), or "changed circumstances" for hardship situations (where the remedy is equitable reformation), or both.

Under Article 79 of the United Nations Convention on Contracts for the International Sale of Goods ("Vienna Convention," "CISG"), for instance:

A party is not liable for a failure to perform if he establishes

⁶⁰*Drinkwater v. Patten Realty Corp.*, 563 A.2d 772, 776 (Me. 1989).

⁶¹*Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 92 N.Y.2d 458, 468, 682 N.Y.S.2d 664, 670 (N.Y. 1998).

⁶²Compare *Merrill Lynch Intern. v. XL Capital Assur. Inc.*, 564 F. Supp. 2d 298, 306 (S.D. N.Y. 2008) (declining to apply doctrine of adequate assurance to credit default swap contracts under New York law because the agreements were not "closely analogous" to contracts for the sale of goods).

⁶³*Spring Creek Holding Co., Inc. v. Shinnihon U.S.A. Co., Ltd.*, 399 N.J. Super. 158, 943 A.2d 881 (App. Div. 2008), certification denied, 196 N.J. 85, 951 A.2d 1038 (2008).

that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of contract or to have avoided its consequences.⁶⁴

Notably, the CISG requires a party to show an “impediment” in order to establish a defense against breach; the language suggests an external force—more akin to the traditionally strict common law doctrine of force majeure than to the broader language of “contingency” described in the “impracticability” standard of the U.C.C. It may be difficult to justify non-performance on the basis of a financial crisis under Article 79, to the extent that a party must show the crisis amounts to an impediment making performance impossible, rather than merely circumstances in which a party is likely to find performance to be economically challenging. In any event, the remedy is exemption from performance for the period while the impediment exists. Under the CISG, there is no hardship provision, so the court or the arbitral tribunal will have to fill that gap.

The UNIDROIT Principles of International Commercial Contracts, purporting to reflect European sales laws, on the other hand, permit the reformation of contracts when a party encounters “Hardship,” which is defined as when:

[T]he occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished . . .⁶⁵

UNIDROIT notes that a party may not be excused from performance merely because the terms of the contract have become “onerous”; however, if the events occurring after the formation of the contract could not “reasonably have been

⁶⁴United Nations Convention on Contracts for the International Sale of Goods, U.N. Doc. A/Conf.97/18 (Annex I), Art. 79. (April 10, 1980), reprinted in United Nations, Official Records of the United Nations Conference on Contracts for the International Sale of Goods 178 (1981); ratified by the United States and published at 52 Fed. Reg. 5262-02 (March 2, 1987). Note that the CISG applies to an international contract entered into by a U.S. party and a party from another signatory nation, unless the contract specifically provides for non-CISG terms or the law of a non-signatory nation. As federal law, under the Supremacy Clause the CISG supersedes state U.C.C. statutes when it applies.

⁶⁵International Institute for the Unification of Private Law (“UNIDROIT”), Principles of International Commercial Contract, Chapter 6, Section 2, Article 6.2.2 (2004), <http://www.unidroit.org/english/documents/2004/study50/s-50-098-e.pdf> (last visited April 7, 2010).

taken into account,” are beyond that party’s control, and that party has not assumed any risk of those events, then the party may request a renegotiation of the terms of the agreement. If the renegotiations are not completed within a reasonable time, either party may then seek reformation or termination of the contract in court.

The Principles of European Contract Law also include a hardship provision which reflects similar considerations: parties are required to renegotiate for purposes of adaptation or termination if “a change of circumstances” occurs after the formation of the contract which could not reasonably have been taken into account, and if the affected party should not be required to bear the risk of the changed circumstances under the terms of the contract.⁶⁶ If no agreement is made within a “reasonable period,” they may seek an adaptation of the terms or termination in court.⁶⁷

V. General Conclusion

The financial crisis may have damaged world credit markets and economies so broadly and so severely as to resemble a natural disaster—indeed, at the time Alan Greenspan described the crisis as a “credit tsunami”—but nonetheless, claims that the crisis disrupted relationships between contractual parties so as to excuse performance of long-term obligations have not fit neatly within existing legal doctrines. Parties should expect that courts will construe contractual force majeure provisions and MAC clauses narrowly, and such provisions often decline to expressly excuse performance on such grounds. Moreover, courts have traditionally been reluctant to find that adverse circumstances in the general economy are unforeseeable at the time of contract or create material problems for the parties’ performance from a longer-term perspective. While such arguments may find some success in particular transactions or circumstances, counsel should be advised to review such doctrines carefully in light of the relevant facts and contractual language.

⁶⁶Commission on European Contract Law, *The Principles of European Contract Law* (“PECL”), Article 6:111 (1999).

⁶⁷*Id.*