

Tuesday, May 19, 2009

30 Rockefeller Plaza — New York City

The Ins and "Outs" of Contractual Performance in Today's Economy

Topics to be Discussed

As the global financial crisis continues to unfold, what litigation tactics will be used to avoid long-term contractual obligations? The panel will discuss the increased use of force majeure claims, "material adverse effects" clauses, "changed circumstances" and "demands for adequate assurances" in high profile litigation and international arbitration cases. How will typical and standard contract clauses dealing with such issues in existing contracts fare under attack? How can lawyers draft more effective clauses going forward?

Program

9:00 - 9:30: Registration and Networking Breakfast
9:30 - 11:00: Moderated Panel
11:00 - 11:30: Questions & Answers

Introductory Remarks

Gov. George E. Pataki, Counsel, Chadbourne & Parke LLP

Panel

Oliver J. Armas, Partner, Chadbourne & Parke LLP
Thomas J. Hall, Partner, Chadbourne & Parke LLP
Alex San Miguel, General Counsel, GLG Partners, Inc.
Prof. Jack F. Williams, Managing Director, BDO Consulting (BDO Seidman, LLP)

Moderator

J. Allen Miller, Partner, Chadbourne & Parke LLP

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Force Majeure / Impossibility

The doctrine of force majeure allows a party to suspend or avoid performance when a supervening event beyond its control makes performance impossible. The event must not have been foreseeable at the time of contract, and generally the event must be shown to be a proximate cause of the failure to perform. Typical force majeure events might include Acts of God (such as natural disasters), riots, strikes, wars or government actions.

A. United States

- i. **Basic Principles:** Many U.S. states recognize, as a matter of common law, defenses of impossibility or impracticability to excuse non-performance of a contract when there is no express contractual clause. Generally, such defenses apply 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. The doctrine is narrowly applied.
 - a. *Restatement (2nd) of 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."
 - b. *UCC § 2-615:* "Delay in delivery or non-delivery in whole or in part by a seller ... is not a 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 with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid."
- ii. **Express Provisions:** Parties frequently negotiate contract clauses which specify events under which non-performance will be excused. Typically, parties agree to suspend performance until the event no longer prevents performance. If the force majeure event continues beyond a stated period, the contract may give the right to terminate performance. Parties may also negotiate to receive some payments during the suspension. 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 Acts of God. In addition, clauses may include a

broader "catchall" clause. Many courts apply the principle of *ejusdem generis* to interpret these definitions, by interpreting the catchall clause narrowly to encompass only events similar to those specifically described.

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 9/11 is not a sufficient proximate cause to constitute a force majeure event.

iii. Select U.S. Jurisdictions:

a. New York: The common law defense of impossibility applies only to the destruction of the means of performance by an Act of God, by Vis Major, or by law, and has limited scope. The impossibility cannot have been foreseen or guarded against in the contract. Financial disadvantage generally does not permit an impossibility defense, even if unforeseeable at the time of the contract.

1. *Donald J. Trump v. Deutsche Bank Trust Co. Americas*, No. 26841/2008 (N.Y. Sup. Ct. Queens Co.). In a case filed in November 2008, Donald Trump sought an injunction postponing the maturity date of a \$330 million loan for the construction of the Trump International Hotel and Tower in Chicago. Trump argues, in part, that the global economic crisis is a Force Majeure Event as defined in the loan agreement, and that his obligation to repay should be suspended until economic conditions improve because units in the building are not selling due to the global economic crisis. Specifically, Trump argues the financial crisis falls within a broad catchall provision of the contract's definition of a Force Majeure Event: ". . . **(xi) any other event or circumstance not within the reasonable control of Borrower or any Trade Contractor.**" The force majeure issue has not yet been adjudicated, and the case has been stayed pending settlement discussions.

The current economic slump is very severe and beyond Trump's control. On the other hand, it is not clear that the economic crisis was unforeseeable or that performance is strictly impossible. The court may also inquire whether the financial crisis is a proximate cause of Trump's alleged inability to perform the contract.

2. *Hoosier Energy Rural Elec. Cooperative, Inc. v. John Hancock Life Ins. Co.*, No. 1:08-cv-01560-DFH-DML (S.D. Ind. Nov. 25, 2008). In a case decided under New York law by an Indiana federal court, the owner-operator of a power plant in a Sale In - Lease Out ("SILO") agreement obtained a preliminary injunction enjoining its lessors from enforcing the terms of the SILO agreement. When the plaintiff's guarantor's credit rating was downgraded, the power plant operator was required under the agreement to find another counterparty to a swap agreement. Despite efforts, the plaintiff was unable to find a satisfactory partner. The court granted a preliminary injunction, holding that the extent of the credit crisis was not foreseeable when the SILO agreement was executed, and permitted the plaintiff 120 days to complete a new swap agreement.
3. *Kel Kim Corp. v. Central Markets, Inc.*, 70 N.Y.2d 900 (1987). Lessee, operating a roller skating rink, failed to maintain its \$1 million insurance policy required by lease because of a crisis in the liability insurance industry. The impossibility defense was rejected because the possible unavailability of insurance coverage was foreseeable when the lease was executed with an insurance requirement. Lessee could not rely on catchall applicable to "**other similar causes beyond the control of such party**" which was construed to apply to events similar to the more traditional force majeure elements in the clause.
4. *Barclays Business Credit, Inc. v. InterUrban Broadcasting of Cincinnati, Inc.*, No. 90 Civ. 2272 (MJL), 1991 WL 258751 (S.D.N.Y. Nov. 27, 1991). A company's repayment of a loan to finance its business of operating radio stations was not excused where the only evidence of impossibility was an economic slowdown in one of the company's metropolitan markets adversely affecting the ability of the company

to repay: "[I]t appears that [the events alleged to render 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 hardship is the basis."

b. Delaware: Courts have recognized that 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.

1. *Rohm and Haas Co. v. The Dow Chem. Co.*, C.A. No. 4309-CC (Del. Ch.). In January 2009, Rohm & Haas sued for specific performance of a merger agreement with Dow Chemical. Dow, the acquirer, postponed the closing after its consummation of a proposed joint venture with the Kuwaiti national petrochemical company, under which Dow would have received \$9 billion, fell through. In support of its defense of impossibility, Dow also pointed to:

- the rapid acceleration of the downturn in the global economy and financial markets;
- an unprecedented falloff in Dow's earnings and demand since December 2008;
- deteriorating conditions of a 19-bank consortium providing bridge financing;
- dramatic changes in Dow's ability to comply with the debt-to-EBITDA covenant under the expected bridge loan;
- severe downgrades to Dow's credit rating; and
- pronouncements of rating agencies that Dow's rating would be lowered below investment grade if the merger as initially signed was consummated.

The court issued no ruling as the parties announced a settlement on March 9, 2009, with Dow paying a reduced equivalent price per share.

2. *J & G Assocs. v. Ritz Camera Centers, Inc.*, Civ. A. No. 9811, 1989 WL 115216 (Del. Ch. Oct. 3, 1989). A municipal parking authority sought to excuse its non-performance on its lease to a parking garage lessee due to commercial impracticability, when structural damage requiring demolition of the garage was discovered shortly after the five-year lease was signed. In denying the tenant's motion to dismiss, the court found discovery was required but noted with interest the clause in the lease that required the authority to perform despite any fire, explosion or other damages. The court also noted that if the event was not covered by the force majeure clause, continued performance would be likely to be commercially impracticable, since the authority would be required to shut down the garage one year for repairs in order to meet its obligations to a tenant who comprised 3% of the garage's annual revenues.
- c. Texas: Negotiated force majeure clauses are preferred, and courts generally decline to read common law force majeure concepts into them. However, Texas law recognizes the doctrine of commercial impracticability.
1. *Sun Operating Limited Partnership v. Holt*, 984 S.W.2d 277 (Tex. Civ. App. 1998). Court reversed trial court's jury instruction that lessors of an oil field were required to exercise due diligence to avoid or overcome a force majeure event, when the contract contained no such requirement: "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."
 2. *Centex Corp. v. Dalton*, 840 S.W.2d 952 (Tex. 1992). A corporation acquiring thrifts was excused from failure to pay a contractual finder's fee when federal bank regulators prohibited payment of the fee. In this case, the Texas Supreme Court recognized the Restatement (2d) of Contracts § 261.

B. Select International Jurisdictions:

- i. United Nations Convention on Contracts for the International Sale of Goods ("Vienna Convention," "CISG"):
 - a. CISG Art. 79: A party is not liable for a failure to perform if he establishes 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.
- ii. European Examples: Germany, Poland
 - a. Germany
 - German Civil Code, Section 275 (Exclusion of the duty of performance):
 - Performance is excused if objectively impossible.
 - The obligor may refuse performance that requires expense and effort which in good faith is grossly disproportionate to the interest in performance of the obligee.
 - b. Poland: Force majeure is recognized under Polish law, although the concept is not defined in the Polish Civil Code. Polish jurisprudence requires that an event be extraordinary (i.e., one that cannot be foreseen or prevented), external and irresistible. In particular, force majeure events include natural catastrophes, public disturbances, or, in limited instances, public actions. Parties may also define a force majeure event by contract.
- iii. CIS Examples: Russia and Ukraine
 - a. Civil Code of the Russian Federation, Section 401(e): an obligor will not be liable for non-performance in the case of circumstances, "not provided for by law or the contract" that constitute force majeure. Such circumstances do not include violations of the contract on the part of the obligor's agents, the absence of necessary goods on the market, or the obligor's lack of necessary funds for performance. Courts also require that there was no fault of the defendant in the occurrence of such circumstances and that there existed a cause-effect relationship between the force majeure circumstances and the impossibility of the defendant to properly perform its obligations.

- *Resolution of the Federal Arbitrazh Court for the Eastern-Siberian District, dated May 04, 2006 on Case A10-8797/05-15-F02-1941/06-C2.* In this case the court recognized that proper performance of obligations by the defendant was impossible due to force majeure circumstances, *i.e.* frost penetration of land due to a decrease of the temperature.
 - *Resolution of the Federal Arbitrazh Court of the Moscow district, dated February 14, 2006 on Case No KG-A40/264-06* (recognizing a breakdown in the electricity supply as force majeure circumstances).
 - *Resolution of the Federal Arbitrazh Court for the Eastern-Siberian District, dated June 27, 2001 on Case A33-10697/02-c2-F02-1865/03-C2.* In this case the court established that the fire could not be deemed as force majeure circumstances and released the defendant (bailee) from responsibility to the claimant (bailor) for damage to the products delivered to the defendant. The court stated that the defendant shall have liability for the occurrence of the fire since the defendant did not take the proper fire-safety measures to prevent the fire.
- b. Civil Code of Ukraine, article 617: "a party who breaches an agreement is freed from responsibility for the breach if it can prove that the breach occurred as a result of an accident or an insurmountable force. Occurrences that are not considered an accident include the failure of the obligor's agents to fulfill their obligations under the contract, the absence of goods on the market that are required for the fulfillment of the contract, and the obligor's lack of necessary funds."
- iv. Latin American Examples: Argentina, Mexico, Brazil
- a. Argentina
1. Argentine Civil Code, Art. 513: The debtor is not liable to its creditor where failure to pay arises from force majeure, unless:
- the debtor had assumed the risk in interest; or
 - the event was caused by debtor; or

- the debtor had been already in default before the force majeure event.
 - 2. Argentine Civil Code, Art. 514: Force majeure is recognized where event could not have been foreseen, or if foreseen, could not have been avoided.
- b. Mexico
 1. Mexican Federal Civil Code, Sections 2017 and 2111: As a general principle, the breaching party is not liable in case of force majeure or fortuitous events. The obligation becomes ineffective, unless:
 - It is otherwise agreed by the parties.
 - The breaching party caused it or contributed to it.
 - The law established otherwise.
 2. Mexican Federal Civil Code, Sections 1827 - 1828. Performance of impossible acts is prohibited by Mexican law. Performance is impossible if it cannot take place by reason of its incompatibility with the laws of nature or a judicial principle that must necessarily govern it; and such incompatibility or impossibility is an insurmountable obstacle to its realization.
- c. Brazil
 1. Brazilian Civil Code, Article 393: A debtor is “not responsible for losses resulting from fortuitous or force majeure events,” unless the contract explicitly provides for such responsibility.
- v. Middle Eastern Example: United Arab Emirates.
 - a. UAE law looks to the intent of the parties as manifested by the language used in the clause, including any enumeration of force majeure events and broad, "catchall" clauses.
 - b. UAE law will imply force majeure relief into a contract where there is no express force majeure provision.
 - c. The UAE Civil Code recognizes impossibility of performance. In addition, UAE Article 893 grants judges and arbitrators broad power to terminate contracts; the scope of this

provision is arguably broad enough to include global economic conditions.

- UAE Civil Code, Article 273: "In contracts binding on both parties, if force majeure supervenes which makes the performance of the contract impossible, the corresponding obligation shall cease and the contract shall be automatically cancelled. In the case of partial impossibility, that part of the contract which is impossible shall be extinguished, and the same shall apply to temporary impossibility in continuing contracts, and in those two cases it shall be permissible for the obligor to cancel the contract provided that the obligee is so aware."
- UAE Civil Code, Article 893: "If any cause arises preventing the performance of the contract or the completion of the performance thereof, either of the contracting parties may require that the contract be cancelled or terminated as the case may be."

vi. Asian Example: India

- a. Force Majeure under Indian law requires proof of three elements:
- the force majeure event must not have been caused by the defaulting party;
 - the cause must be unforeseeable; and
 - the cause must make performance wholly impossible.

vii. Other Common Law Jurisdictions: United Kingdom and Canada

- a. English law recognizes the enforceability of force majeure provisions in contracts governed under English Law.
- *JP Morgan Chase Bank v. Springwell Navigation Corp.*, [2008] EWHC 1793, 2001-404 (High Court of Justice, Queen's Bench Div., Commercial Court) (U.K.) (upholding the invocation of a force majeure clause in an international contract governed by UK law).
 - *Thames Valley Power Ltd. v. Total Gas & Power Ltd.*, [2005] EWHC 2208, 2005-668 (High Court of Justice, Queen's Bench Div., Commercial Court) (U.K.) (finding

that a party was not justified in invoking the force majeure provision of a contract).

- b. Canada: it is well established that force majeure provisions are enforceable in long-term contracts for the sale of energy resources, such as oil and gas, and Canadian courts have recognized the doctrine in other contexts.
 - *Thibadeau v. Air Canada*, [2005] F.C. 1621 (Can.) (refusing to accept a defense of force majeure where the circumstance creating the violation was reasonably foreseeable);
 - National Energy Board Act Part VI (Oil and Gas) Regulations, SOR /96-244 (indicating that contracts for oil and gas should provide for the type of force majeure relief available to the parties).
- viii. General Principles of Law, Lex Mercatoria: ICC Sample clauses, Unidroit principles, PECL, etc., see CD materials.

C. Drafting Considerations

- i. Open v. Closed Clauses:
 - a. Open clauses - describe in general language the sorts of situations in which a force majeure clause will apply.
 - b. Closed clauses - specify incidents which will be considered force majeure events.
 - c. Combined clauses - specify events but contain "catchall" provisions. Courts may apply the principle of *ejusdem generis* to limit general language to the scope of events specified in the clause.
- ii. Sample clause:
 - a. "Neither party shall be liable for any delay in, or failure of, its performance of any of its obligations under this Agreement if such delay or failure is caused by events beyond the reasonable control of the affected party, including but not limited to any acts of God, governmental embargoes, restrictions, quarantines, strikes, riots, wars or other military action, civil disorder, acts of terrorism, rebellions or revolutions, fires, floods, vandalism, sabotage or the acts of third parties."

- b. "Neither party shall be liable . . ."
 - 1. The contract applies to both parties by agreement, but the clause may be drafted to provide relief to one party only.
- c. ". . . including but not limited to any acts of God, governmental embargoes, . . . sabotage or the acts of third parties."
 - 1. The "catch-all" language is found in the beginning: "including, but not limited to . . .". These 'catch-all' phrases are usually interpreted narrowly.

Changed Circumstances / MAC 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") clauses or ("Material Adverse Effect" clauses) are familiar elements of merger agreements, and have become the subject of increasing attention and negotiation in recent decades. Many other jurisdictions, particularly those influenced by the civil law, allow courts broad power to rewrite contracts in limited circumstances where performance would be oppressive.

A. U.S.: Material Adverse Effect / Material Adverse Change ("MAC"):

MAC clauses allow contracting parties to specify future scenarios in which either or both of the parties do not want to continue the deal on the same terms. They can thereby serve as means to break up a transaction or to force renegotiation of the agreement. Generally, buyers seek broad MAC clauses and sellers prefer narrow clauses that make the deal more likely to close.

- i. Theories: MAC clauses are used to allocate risk between a purchase and seller when there is an interim period between the initial signing of an agreement and closing.
 - a. Symmetry theory: when risk is not allocated symmetrically between buyer and seller, the MAC clause is a contractual readjustment of that risk.
 - b. Investment theory: the MAC clause forces the seller to continue to preserve going concern value during interim period.

- c. Renegotiation leverage theory: the MAC clause allocates leverage in renegotiations.
- ii. Traditional vs. Modern MAC Clauses:
 - a. Traditional: Parties seek to address unforeseen risk through vague language, under a standard-based system.
 - b. Modern: Clauses are intensely negotiated, including detailed provisions interpreted under a rule-based system. Parties use the clause in litigation more as an excuse for non-performance than as a tool to obtain leverage.
 - 1. Modern MAC clauses can increase closing risk, creating uncertainty and affecting public markets when public companies are involved.
- iii. Comparative View
 - a. In the U.S., the MAC clause is a matter of contract.
 - b. UK law distinguishes between private and public companies.
 - 1. In private company transactions, a MAC is a matter of contract.
 - 2. In public transactions (where the target is a publicly traded company on a UK market), a MAC's content and structure are regulated by the Takeover Panel. MAC clauses may not contain any exceptions and thus are generally standardized.
- iv. Select U.S. Jurisdictions:
 - a. New York:
 - 1. *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001) (applying New York law). In a prominent case arising from the merger of two large food distributors, a Delaware court ruled on a merger agreement governed by New York law and held that a temporary drop in earnings did not constitute an MAE. The agreement defined an MAE as:
 - "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 . . ."

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. The court rejected this argument on multiple grounds:

- Unknown Event: Cyclical downturns in financial performance were foreseeable.
- Substantial Threat: Unexpected poor performance of subsidiary or division inadequate; company-wide performance is focus.
- Durational Significance: Short-term downturn in earnings not enough.

2. *Solutia Inc. v. Citigroup Global Markets Inc.*, No. 08-01057-pcb (Bankr. S.D.N.Y.). Chemical manufacturer in Chapter 11 proceedings obtained commitment letters in October 2007 from three banks to provide financing for the company's reorganization plan. 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 downturn in the finance markets. Following negotiations, the banks provided loans on new terms.

3. *Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438 (S.D.N.Y. 1994). MAC occurred where target airline in bankruptcy suffered approximately between 20-40% declines in bookings over three-month period.

b. Delaware: Delaware courts generally follow the approach in the IBP case. Thus, a MAC will generally not be found to have occurred unless the events giving rise to it were unforeseen, present a substantial threat, and are durationally significant.

1. *Frontier Oil Corp. v. Holly Corp.*, No. Civ. A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005). Mass toxic tort lawsuits against a target oil company did not

constitute a MAC sufficient to allow the acquirer to walk away from the deal.

2. *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del Ch. 2008). Target corporation did not suffer MAC when (1) its earnings fell by 20%; (2) its forecasted future earnings were projected to drop; (3) its net debt increased by approximately 5%; and (4) two of the target's divisions, comprising approximately 25% of its earnings, faced short-term difficulties caused by temporary restructuring costs and macroeconomic conditions.

c. Tennessee: Recent merger case involved the assertion that MAC triggered by general economic downturn.

1. *Genesco, Inc. v. The Finish Line, Inc.*, No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007). Target of \$1.5 billion merger sued for specific performance after its earnings approached ten-year low. The MAC clause contained carve-out for economic conditions affecting all companies in the target's industry generally. Court found MAC not triggered because declining earnings were caused by general macroeconomic conditions.

B. International Cases

i. Theories

a. France: **Théorie de l'Imprévision** (see *Gaz de Bordeaux* below)

b. Argentina: **Teoría de la Imprevisión / Excesiva Onerosidad**

Argentine Civil Code, Article 1198: Where performance becomes excessively burdensome due to extraordinary and unforeseeable events, the affected party can request the termination of the contract. The other party may prevent the termination by offering to equitably ameliorate the effects of the contract.

c. Mexico:

- Mexican Federal Civil Code, Section 1796. As a general rule parties must comply with the terms of the contract (*pacta sunt servanda*). Mexican Federal Courts have

strongly disfavored theories of changed circumstances and undue hardship.

- d. United Arab Emirates: Recognizes doctrine of unforeseen circumstances derived from the French *Théorie de l'Imprévision* where a performance would be oppressive to one of the parties. Under Civil Code Article 249, contract can be revised to restore economic equality between the parties, as when materials prices rise dramatically.
- Civil code, Article 249: "If exceptional events of a general nature occur which were not capable of being foreseen, and the occurrence of which renders performance of a contractual obligation oppressive, albeit not impossible, for the obligor as it threatens him with exorbitant loss, it shall be permissible for the judge, in accordance with the circumstances, and after weighing up the interests of the two parties, to bring the oppressive obligation back to what is reasonable, if justice so requires. Any agreement to the contrary shall be null."
- e. Germany: **Wegfall der Geschäftsgrundlage**
- Civil Code, Section 313 - Party can seek change in where the parties would not have entered the contract as formed had the material adverse change existed then. Termination is a last resort, to the extent contractual modification is not feasible.
 - Civil Code, Section 314 - Excuses non-performance if party cannot be expected to continue the contractual relationship until the agreed termination date. Claims for damages may survive termination under this Article.
- f. General principles of law, *lex mercatoria*: ICC Sample clauses, Unidroit principles, PECL, etc., see CD materials.

ii. Select International Cases

- a. *Compagnie Generale d'Eclairage de Bordeaux ["Gaz de Bordeaux"] v. Ville de Bordeaux*, Conseil d'Etat, Rec. 125, concl. Chardenet, 30 March 1916).

Gas supplier contracted to deliver gas to the city of Bordeaux at fixed rates over a period of years. The outbreak of World War I caused the price of coal to increase drastically and gas supplier requested an increase in the

contractual rate. The court recognized that fluctuations in costs should be anticipated in any long-term fixed price contract. But here the increased cost exceeded the "outer limits" of what could have been contemplated when the contract was executed. Case was remanded for an equitable adjustment of the contract.

b. ICC Award Case No. 1512 (1971):

In this case, a Pakistani bank agreed to guarantee shipments of cement to an Indian cement company. Pakistan imposed emergency legislation making payment to an Indian party illegal due to armed conflict between the two countries.

The arbitrator declined to excuse the bank's non-performance on the grounds that the change in circumstances was not unforeseeable since, under general principles of law, armed hostilities between countries with a history of antagonism are predictable.

c. *Himpurna California Energy Ltd. (Bermuda) v PT (Persero) Perusahaan Listrik Negara (Indonesia)*, Final Award of 4 May 1999, XXV Y.B. Int'l Comm. Arb. 13 (2000):

In this case, a U.S. entity contracted with an Indonesian state-owned power company to build four geothermal units and sell it the output for a period of 30 years. Power company relied on presidential decrees suspending or canceling almost 70 independent power projects due to the financial and monetary crisis in Indonesia.

The arbitrators found that the Indonesian economic crisis was not unforeseeable. "[P]arties entering into international contracts cannot claim unawareness of the risks of macro-economic adversities ... their effects may be extreme, but are nonetheless *within the contemplation of the signatories.*"

C. Drafting Considerations

- i. Concerns peculiar to the transaction will drive drafting.
- ii. Specific consideration:
 - a. MAC clause may define "materiality," either in monetary or quantity terms.

- b. Forward-looking language (i.e., "reasonably expected to have a material adverse effect ...") in the MAC clause increases the likelihood of litigation.
- c. Tips:
 - 1. **Seller's counsel** will usually negotiate for the exclusion of specified events, including failures to obtain governmental approvals, regulatory changes affecting the seller's industry, events affecting the US economy, terrorist attacks, and changes in GAAP.
 - 2. **Buyer's counsel** will usually negotiate for the inclusion of forward-looking language, particularly on events reasonably likely to materially decrease short-term earnings, and for the inclusion of known events that could hurt the seller's earnings.

iii. Samples

- a. Traditional MAC clauses:
 - 1. An event, change or occurrence which individually or together with any other event, change or occurrence would have a material adverse change.
 - 2. "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.
- b. Modern MAC clauses:
 - 1. "Material Adverse Effect" means, with respect to the Company, an effect, event, development or change that is materially adverse to the business, results of operations or financial condition of the Company and the Company Subsidiaries, taken as a whole; provided, however, that in no event shall any of the following, alone or in combination, be deemed to constitute, nor shall any of the following be taken into account in determining whether there has been, a Material Adverse Effect: (a) a decrease in the market price or trading volume of Company Common Shares (but not any effect, event, development or change underlying such decrease to the extent that such effect, event, development or change would otherwise

constitute a Material Adverse Effect); (b) (i) changes in conditions in the U.S. or global economy or capital or financial markets generally, including changes in interest or exchange rates; (ii) changes in applicable Law or general legal, tax, regulatory or political conditions of a type and scope that, as of the date of this Agreement, could reasonably be expected to occur, based on information that is generally available to the public or has been Previously Disclosed; or (iii) changes generally affecting the industry in which the Company and the Company Subsidiaries operate; provided, in the case of clause (i), (ii) or (iii), that such changes do not disproportionately affect the Company and the Company Subsidiaries as compared to other companies operating in the industry in which the Company and the Company Subsidiaries operate; (c) changes in GAAP; . . .

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 UCC Article 2 (sale of goods) in 1978, but courts are gradually expanding its application to common law.

A. United States

- i. Background Authorities
 - a. *UCC § 2-609 (1)(1978)*: In contracts involving the sale of goods, "[w]hen 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."
 - b. *Restatement (2d) of Contracts § 251(1981)*: "Where reasonable grounds arise to believe that the obligor will commit a breach by nonperformance that would of itself give the obligee a claim for damages for total breach under § 243, the obligee may demand adequate assurance of due performance and may, if reasonable, suspend any performance for which he has not already received the agreed exchange until he receives such assurance."

ii. Application

- a. "Reasonable grounds": 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:
1. Violation of a loan covenant is probably insufficient grounds to seek adequate assurance.
 2. Confirmed reports that a primary working capital facility has been terminated have been found to be sufficient grounds.
 3. Any development causing a company to file a Form 8-K regarding a material adverse event has been found to be adequate.
- b. If reasonable grounds for insecurity exist, a party may make a demand for adequate assurance of due performance; if assurance is not provided, the party that sought assurance may suspend performance for any portion of the contract that is not paid for. Forms of assurance may include:
1. letters of credit;
 2. cash-on-delivery;
 3. cash-in-advance payment terms.

iii. Expansion of Doctrine Outside the Sale of Goods

- a. Alaska: *L.E. Spitzer Co. v. Barron*, 581 P.2d 213, 216-17 (Alaska 1978) (applying the doctrine of adequate assurances to a joint venture agreement between two construction companies).
- b. Colorado: *Carfield & Sons, Inc. v. Cowling*, 616 P.2d 1008, 1010 (Colo. Ct. App. 1980) (holding that the plaintiff in an action on a construction contract was required to demand adequate assurances before treating the contract as terminated).
- c. Connecticut: *Conference Ctr. Ltd. v. TRC*, 455 A.2d 857, 863-64 (Conn. 1983) (extending the doctrine of adequate assurances to the law of constructive eviction).

- d. Florida: *Weisfeld v. Peterseil School Corp.*, 623 So. 2d 515, 519 (Fla. Dist. Ct. App. 1993) (Gersten, J., dissenting in part) (suggesting that the doctrine of adequate assurances applies to an employment contract).
- e. Hawaii: *Romig v. deVallance*, 637 P.2d 1147, 1152 (Haw. Ct. App. 1981) ("although this case involves a transaction in land, whereas Article 2 of the Uniform Commercial Code applies to transactions in goods, we deem it appropriate to analogize [U.C.C. § 2-609]").
- f. Maine: *Drinkwater v. Patten Realty Corp.*, 563 A.2d 772, 776 (Me. 1989) (applying the doctrine of adequate assurances in a dispute over a contract for the sale of real property).
- g. Mississippi: *Patel v. Telerent Leasing Corp.*, 574 So. 2d 3, 7 (Miss. 1990) (noting that the doctrine of adequate assurances has been extended to leasing transactions in Mississippi).
- h. Montana: *The Blackfeet Tribe v. Blaze Constr., Inc.*, 108 F. Supp. 2d 1122, 1140 (D. Mont. 2000) (applying the doctrine of adequate assurances to a contract for construction services, as required by Montana law).
- i. New Hampshire: *McNeal v. Lebel*, 953 A.2d 396 (N.H. 2008) ("Although a right to demand adequate assurance under general contract law has not previously been recognized in our case law, we conclude that the trial court correctly applied the doctrine here. The comment to *section 251 of the Restatement (Second) of Contracts* notes that that section is based upon a principle, 'closely related to the duty of good faith and fair dealing in the performance of the contract,' . . . a duty that has long been an integral component of our common law of contracts.")
- j. New Jersey: *Spring Creek Holding Co. v. Shinnihon U.S.A. Co., Ltd.*, 943 A.2d 881 (N.J. Super. Ct. App. Div. 2008) ("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.' . . . New Jersey courts accept this approach, derived from the Uniform Commercial Codes sale of goods provision . . . and contained in the Second Restatement of Contracts.")

- k. New York: *Norcon Power Partners, L.P. v. Niagara Mohawk Power Corp.*, 92 N.Y.2d 458 (N.Y. 1998) ("It 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.")
- l. Pennsylvania: *Mears, Inc. v. Nat'l Basic Sensors, Inc.*, 507 A.2d 32, 37-38 (Pa. 1986) (holding that an insurance company was required to give the insured "reasonable assurances" of coverage if the insured requests them).
- m. Federal law: *Danzig v. AEC Corp.*, 224 F.3d 1333, 1337-38 (Fed. Cir. 2000) (noting that the law of government contracts has adopted the doctrine of adequate assurances).

B. Select International Rules

- i. *United Nations Convention on Contracts for the International Sale of Goods*:
 - a. Under Article 71 of the CISG, a party may seek assurance of continued performance of a contract for the sale of goods when the other party's conduct, deficiencies in his ability, or his reduced creditworthiness indicate the party will not perform his obligations.
 - b. Under Article 72 of the CISG, a party may declare any contract avoided if the other party declares it will not fulfill its obligations. The party seeking to avoid the contract under Article 72 must only provide notice and seek assurance if time allows.
- ii. *General principles of law, lex mercatoria*: Unidroit principles, PECL, etc. See CD materials.