STATE BAR OF MICHIGAN
BLS
BUSINESS LAW SECTION

The Michigan Business Law JOURNAL

Volume 29
Issue 1
Spring 2009

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Published by THE BUSINESS LAW SECTION, State Bar of Michigan

Force Majeure and Commercial Impracticability: Issues to Consider Before the Next Hurricane or Natural Disaster Hits

By Thomas S. Bishoff and Jeffrey R. Miller

Introduction

When Hurricanes Gustav and Ike hit the U.S. Gulf coast, they had devastating effects on facilities that manufactured goods ranging from resins and oil-based raw materials to finished products. The flooding, wind damage, and loss of electricity forced countless manufacturing operations and distribution centers to cease production or supply temporarily. Declaring force majeure, many suppliers waived the white flag in the hope that their contract provisions, or, alternatively, the terms of the Uniform Commercial Code (UCC), would give them the protection they needed due to their inability to perform under their supply contracts. In such circumstances, sellers are often forced to consider two basic questions frequently under demanding time constraints: (1) what types of events relieve them from their obligation to perform; and (2) what rules govern the implementation of force majeure or commercial impracticability.

This article examines some important considerations surrounding force majeure events and identifies the rights and obligations that apply under both negotiated force majeure provisions and the UCC. In doing so, this article provides a framework for the legal and factual issues surrounding a declaration of force majeure, including what events justify force majeure, what procedures apply under the UCC, and what relief the declaration of force majeure provides. It also provides practice pointers to attorneys negotiating and interpreting force majeure clauses.

What Events Justify Declaration of Force Majeure?

Before entering into a contract, sophisticated parties routinely consider and attempt to negotiate terms that provide protection for anticipated events that might occur during the course of performance. In the automotive industry, for example, it is not uncommon for the parties to account for changes in consumer demand that may impact the buyer's requirements for parts. Nor is it uncommon for parties to account for price fluctuations due to market swings for steel, resins, or other materials.

But there are other events that parties often cannot anticipate. This is the purpose of a force majeure provision. Contracting parties can negotiate a "catch-all" provision that allocates the risks associated with various categories of extraordinary events that, while unlikely to happen, may impact a party's ability to perform. *Black's Law Dictionary* defines force majeure as: "An event or effect that can neither be anticipated nor controlled. The term includes both acts of nature (e.g., floods and hurricanes) and acts of people (e.g., riots, strikes, and wars)."[1] In application, force majeure is a contract doctrine (usually applied as a defense to breach or nonperformance claims) that relieves a party from ongoing performance due to impracticability or impossibility.

The most litigated issue associated with force majeure is the threshold issue of which events fit within its definition and excuse performance. The first place parties should look to answer this question is the contract itself. Like any other contract term, parties are free to negotiate what events they consider to be unanticipated or uncontrollable and to allocate the risks posed by such events. And they often do. Parties routinely include an express force majeure provision that dictates (i) what events trigger declaration of force majeure, (ii) what procedures apply when force majeure is contemplated or declared, and (iii) what relief from performance the provision offers.[2]

When a party is considering whether to invoke an express force majeure provision, it should interpret and apply that provision as any other contract provision. In other words,

it should determine whether the events it is facing truly warrant a declaration that ongoing performance is commercially impracticable or impossible. It should also consider whether its interpretation is reasonable and weigh the possible consequences it would face if the non-declaring party (usually the buyer) objects and the decision to declare force majeure needs to be justified before a jury, court, or arbitrator.

As is often the case, the scope of a force majeure provision provides little clarity and is subject to differing interpretations. Provisions usually consist of nothing more than a laundry list of catastrophic categories of events (e.g., wars, hurricanes, tornados, labor strikes, etc.) that justify non-performance, leaving interpretation to a party's good faith. In other cases, parties do not make any effort to define such events and instead rely on the application of the law to provide protection if it were ever needed. This is where the UCC and the common-law doctrines of commercial impracticability and impossibility come into play.

The doctrine of force majeure is codified in UCC 2-615 ("Failure of presupposed conditions; nondelivery; partial delivery; excuse"). Subsection (a) sets forth the general rule:

> Delay in delivery or nondelivery 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 nonoccurrence of which was a basic assumption on which the contract was made....[3]

While this section aptly structures the relief of force majeure as a protection for sellers, who are most often the parties that declare force majeure, the protection may apply to buyers under appropriate circumstances.[4] In considering UCC 2-615(a) and surveying the caselaw applying it, Professors White and Summers suggest that the doctrine applies when three elements are satisfied: (1) the seller must not have assumed the risk of some unknown contingency; (2) the nonoccurrence of the contingency must have been a basic assumption underlying the contract; and (3) the occurrence of that contingency must have made performance commercially impracticable.[5]

Force majeure cases typically fall within one of two categories. The first category involves sudden calamitous events, including "acts of God," war, labor strikes, etc., that render ongoing performance impracticable, if not impossible. When the appropriate conditions are met, these types of events generally will justify a party declaring force majeure. The second category involves changed economic circumstances that fundamentally alter the anticipated economics of a contract. These types of changed circumstances generally will not justify a party declaring force majeure.

"Acts of God" or Other Extraordinary Events

Contractual force majeure provisions routinely enumerate a list of extraordinary events that parties consider to be beyond their control. Typical provisions include such events as: acts of nature (including fire, flood, earthquake, storm, hurricane or other natural disaster), loss of electricity, cataclysmic loss or damage (including loss of materials or goods in transit), sabotage, arson, war, invasion, acts of hostility from foreign enemies (whether war is declared or not), civil war, rebellion, revolution, military or usurped power or confiscation, terrorist activities, nationalization, government sanctions, blockage, embargos, labor disputes, strikes, and lockouts or interruptions.

These types of extraordinary events demonstrate why the doctrine of force majeure is needed. Parties to a contract cannot be expected to consider and negotiate individual terms for the impact of possible earthquakes, hurricanes, or other events that may disrupt a seller's manufacturing operations and render it unable to meet its contractual obligations. Force majeure relieves parties from the burden of considering categories of unanticipated events.

In the appropriate context, these types of cataclysmic events justify force majeure. But because there is a risk that force majeure may be declared improperly, courts regularly recognize two conditions that must be met for even these types of events to justify nonperformance: (1) the events must be beyond a parties' reasonable control; and (2) the events must make ongoing performance commercially impracticable or impossible.

First, while some extraordinary events are beyond a party's reasonable control, others are not. Clearly, earthquakes, hurricanes, and other acts of God are beyond the control of the parties. But consider the example of a labor strike. Depending on the circumstanc-

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es, a strike may or may not be beyond the reasonable control of management. Because strikes may be avoided by undertaking additional costs, courts may find that the circumstances of a specific strike do not justify force majeure. This is particularly true where a strike impacts a seller's ability to manufacture products for which it has been incurring consistent losses. A court may consider it too convenient for the seller that its failure to compromise on certain labor demands allowed the seller to terminate an unprofitable contract.[6] On the other hand, if a seller is unable to avoid a labor strike notwithstanding its good faith efforts to negotiate a resolution, it may be able to support a claim of impracticability.

There are many circumstances that weigh into whether an event justifies force majeure, and the answer is not always clear.

Second, just because an event specified in a force majeure provision occurs does not automatically operate to excuse performance. The event must truly make performance impracticable or impossible, and it must be the precipitating cause for the inability to perform. For example, a hurricane only relieves a seller of its supply obligations under a contract if the winds, flooding, or loss of power associated with the storm disrupt a seller's manufacturing capabilities. This was the case recently for many sellers impacted by hurricanes Gustav and Ike. The hurricanes caused flooding, loss of power, and plant damage that required many manufacturers to shutdown production for many weeks. There likely were many other plants, however, that, while damaged, could nonetheless continue production. Or the hurricanes may have only impacted production as a catalyst and not a cause. A plant may not be able to rely on force majeure if it were found that its facility was made unduly susceptible to damage from a storm as a result of failure to take reasonable precautions, including maintaining the facility.[7] There are many circumstances that weigh into whether an event justifies force majeure, and the answer is not always clear.

Economic Hardship Is Generally Insufficient

Economic hardship is the second broad category of events. It is widely recognized that economic hardship alone does not justify declaration of force majeure. This category accounts for situations where the anticipated economic variables that a party has in mind when entering into a contract are lost or change, such that a contract becomes unprofitable. While this may result from a variety of circumstances beyond a party's control, economic hardship generally is insufficient to excuse nonperformance. This is because the drafters of the UCC expect that parties understand the allocation of economic risk in a commercial relationship prior to entering into a contract, and the parties must be prepared to "take the good with the bad."

The following situations generally will not justify declaring force majeure:

Contract Unprofitability. The failure to realize anticipated contract profits (or the need to end losses) alone will not excuse nonperformance. The Seventh Circuit aptly summarized this concept when it held:

> A force majeure contract is not intended to buffer a party against the normal risks of a contract. The normal risk of a fixed-price contract is that the market price will change. If it rises, the buyer gains at the expense of the seller...if it falls...the seller gains at the expense of the buyer. The whole purpose of a fixed price contract is to allocate risk in this way. A force majeure clause interpreted to excuse the buyer from the consequences of the risk he expressly assumed would nullify a central term of the contract.[8]

Increased Costs. Under normal circumstances, increased costs are not grounds for force majeure. Comment 4 to UCC 2-615 outlines this general rule, stating that "[i]ncreased cost alone does not excuse performance...."[9] While this rule is simple on its face, Comment 4 includes an exception for circumstances where "the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance."[10] Sellers often argue reliance on this type of exception to justify nonperformance, but courts rarely excuse nonperformance on the basis of increased costs.[11]

Increased Costs Required to "Cover." In addition to the common law rule requiring mitigation of damages, the UCC requires that a party cover where necessary to avoid or minimize damages resulting from nonperformance. Where a sudden calamitous event occurs that renders a seller only able to continue performing if it incurs additional burden or expense (*e.g.*, a seller procuring spot purchases of raw materials on the open market at higher costs to meet its production schedule, a seller incurring increased transportation costs to transport goods from another plant, a seller needing to add addition-

al shifts to compensate for other production shortfalls, etc.), the seller is required to cover and meet its contractual obligations notwithstanding the higher costs.[12]

Termination by Sub-Suppliers. A sub-supplier's termination of a contract generally will not excuse non-performance, unless no alternative source of supply exists or the parties contracted on the basis that only a specific sub-supplier would be utilized. This rule reflects the concept that a seller is deemed to have accepted the risk of its chosen supplier's non-performance.[13]

What Procedures and Rights Apply When Force Majeure Is Declared

When force majeure is declared appropriately the next consideration is the procedures and rights that apply to excuse nonperformance. As with the events that justify force majeure in the first place, negotiated terms often dictate procedures that must be followed to justify temporary or permanent nonperformance. While often also covered by contract, the law implies certain requirements.

The UCC Requires Seasonable Notice and Fair Allocation

The UCC imposes two express requirements. The first requirement is rather obvious: The seller must provide prompt notice. UCC 2-615(c) requires that "[t]he seller must notify the buyer seasonably that there will be delay or nondelivery and, when allocation is required under paragraph (b), of the estimated quota thus made available for the buyer."[14]

The second requirement gives the seller a safe harbor for situations where either (i) the seller has a limited existing inventory of goods to fulfill its contractual obligations, or (ii) the force majeure event impacts only part of the seller's capacity to perform. Under such circumstances, UCC 2-615(b) provides that a seller can satisfy its obligations to buyers by allocating "in any manner which is fair and reasonable."[15] While the standard of "fair and reasonable" is far from defined, it merely requires that a seller treat all of its buyers (whether there are existing orders or anticipated spot buy orders from regular customers) equally and allocate whatever it is able to supply fairly. This rule should prohibit a seller from favoring buyers who pay higher prices. Comment 11 to UCC 2-615 makes this point by stating that "good faith requires, when prices have advanced, that the seller exercise real care in making his allocations, and in case of doubt his contract customers should be favored and supplies prorated evenly among them regardless of price."[16]

The Burden of Due Diligence

In addition to the express UCC requirements, a party contemplating force majeure is subject to a burden of showing due diligence. This burden operates as a condition precedent to excusing nonperformance and requires that the impacted party show that it took all reasonable actions to meet its contractual obligations notwithstanding the force majeure event. The due diligence burden is similar to the concept of "cover" discussed above. Faced with an event that poses risk to a seller's ability to manufacture or deliver its products, the seller cannot sit idly by and claim impracticability. Instead, it must do everything within its power to avoid or minimize the impact of the event, regardless of the cost. Generally speaking, a seller assumes the risks associated with performance, and if it can only perform as a result of an event by incurring additional costs or additional burden, it must do so to avoid breach of contract. To gain relief, the seller would need to demonstrate its due diligence and that it could not perform despite its significant and good faith efforts to do so.

In an often-cited case stemming from a hurricane, the Third Circuit Court of Appeals found that force majeure is not justified were a party fails to meet its due diligence burden:

> For *force majeure* events to excuse nonperformance, some correlation must be drawn between the occurrence of an event and the obligation of the nonperforming party. We think that Gulf must show that it exercised due diligence to overcome the effects of the specific *force majeure* events. Gulf must show that it tried to limit the problem and was not able and that it did everything in its control to prevent or minimize its happening. Gulf must show that its source of supply was either unavailable or undeliverable due to *force majeure* occurrences. To show that its source of supply was unavailable or undeliverable, Gulf must prove that despite its efforts, it was not able to produce its maximum daily contract

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warranty of 625 Mmcf from either its regular or its reserve sources.[17]

When force majeure is declared appropriately and its requirements are met, a party is relieved from the obligation to continue to perform. That relief, however, may be temporary or otherwise limited in scope. UCC 2-615(a) provides relief for either a "[d]elay in delivery" or "nondelivery in whole." Therefore, under the UCC, and as is often required in force majeure provisions, when a force majeure event presents only a temporary obstacle to performance, the party is expected to resume performance when commercially practicable. If, however, the event renders a party unable to perform in whole, it should be relieved from any ongoing performance and the contract terminated by its terms (assuming there is a force majeure clause) or operation of law.

[t]he doctrine of force majeure affords parties the opportunity to allocate the risks associated with the variety of events that are unanticipated at the time of contracting but may occur during the period of performance.

Practice Pointers

A survey of force majeure case law suggests that practitioners consider the following practice pointers when negotiating or interpreting contracts that contain force majeure clauses.

Draft Force Majeure Terms Carefully. Parties all too often rely on generic force majeure provisions that are not tailored to unanticipated circumstances that may apply to their specific business relationships. In negotiating provisions, parties should take care to anticipate the unanticipated. They should do this in two ways. First, where possible, they should include terms for the types of specific events that may pose a risk of non-performance and dictate the procedures and relief that would apply if such events were to occur. For example, because the risk of a labor strike is particularly applicable to a manufacturing contract, the contract may warrant specific detail regarding the rights and obligations of the parties in the event of a strike. Second, caution must always be taken for the truly extraordinary types of events. Notwithstanding the nature of a specific business relationship, a natural disaster or other type of event may impact the ability to perform. Therefore, while specificity is helpful to account for certain situations, force majeure terms should also include a broad scope of application.

Don't Declare Force Majeure as a Pretext to Negotiate Higher Prices. Force majeure is not a "get out of jail free" card. Courts are very hesitant to allow parties to avoid contractual obligations, and they are particularly hesitant when an event may be used as a pretext to avoid performance under an unprofitable contract. Performance is not impracticable or impossible when a seller faced with an event contacts the buyer and states that it may need to declare force majeure and can only continue to perform if the buyer pays economic concessions. Such a letter will likely be a prominent exhibit to a lawsuit brought by a buyer asserting breach of contract and claiming that force majeure was not justified. A seller's due diligence and cover obligations more often than not will require that it explore options and bear the expense of any higher costs incurred to continue performing.

Document Efforts to Perform. A party declaring force majeure should take care in generating a record or paper trail evidencing its efforts to perform. The due diligence burden requires that all reasonable efforts to perform be exhausted before performance may be excused. Therefore, a party should record its efforts to support its burden of proof. All avenues to perform should be explored and all letters, emails, purchase orders, or other records should be preserved.

Force Majeure Declared Low in a Supply Chain May Not Relieve Others Higher in the Chain. Just because a supplier low in a supply chain declares force majeure, others still need to perform their due diligence before making a similar declaration. Using the automotive supply chain as an example, if a storm renders a raw steel supplier unable to meet its supply obligations to a Tier 1 buyer, the Tier 1 may not be able to declare force majeure for its contracts with its original equipment manufacturer customer if it could nonetheless be able to find raw materials from other suppliers. All parties in a supply chain are subject to their own independent due diligence burden.

Conclusion

By contract or operation of law, the doctrine of force majeure affords parties the opportunity to allocate the risks associated with the variety of events that are unanticipated at the time of contracting but may occur during the period of performance. Notwithstanding its position in contract law as a safety net, the doctrine of force majeure is often misunderstood and regularly misapplied. Most commonly, sellers make the mistake of relying on force majeure provisions to avoid performance on unprofitable contracts or declare

force majeure as a pretext to extract economic concessions. A basic understanding of the doctrine, however, will go a long way to avoid pitfalls that frequently arise following natural disasters and other unanticipated events.

NOTES

1. *Black's Law Dictionary* (7th Ed 1999).

2. Even where an express force majeure clause is not included in a sale of goods contract, force majeure terms may nonetheless be implied and enforced through usage of trade, course of dealing, and course of performance. *See* MCL 440.2202 (contract may be "explained or supplemented ... by source of dealing or usage of trade (section 1205) or by course of performance (section 2208)....")

3. MCL 440.2615(a).

4. While the UCC expressly provides relief only to sellers, the Comments to UCC 2-615 suggest that buyers may likewise take advantage of the UCC's protections under certain circumstances. *See* Comment 9 to MCL 440.2615 ("On the other hand, where the buyer's contract is in reasonable commercial understanding conditioned on a definite and specific venture or assumption as, for instance, a war procurement subcontract known to be based on a prime contract which is subject to termination, or a supply contract for a particular construction venture, the reason of the present section may well apply and entitle the buyer to the exemption.").

5. 1 *White and Summers Uniform Commercial Code* § 3-10 (5th Ed 2006).

6. *Id.* at section d ("A Strike as a Basis for a Finding of Commercial Impracticability").

7. *Gulf Oil Corp v Fed Energy Regulatory Comm'n*, 706 F2d 444, 453 (3d Cir 1983) (finding that gasoline supplier did not prove that a hurricane caused its inability to supply the gasoline, holding that "[i]f the *force majeure* event causes the inability to deliver the gas rather than the inability to obtain the gas, the supplying party has the burden of providing that the inability to deliver was not caused by routine maintenance.").

8. *Northern Indiana Pub Servs Co v Carbon County Coal Co*, 799 F2d 265, 275 (7th Cir 1986); *see also Karl Wendt Farm Equip Co v Int'l Harvester Co*, 931 F2d 1112, 1117 (6th Cir 1992) (applying Michigan law) (holding that "events which in the nature of things do not render performance impossible, but only render it more difficult, burdensome, or expensive, will not operate to relieve [a party of its contractual obligations]" and, on the basis of this rule, finding that International Harvester could not rely on the defense of commercial impracticability to evade performance under a dealership agreement because it sold its farm equipment division merely to curb losses of over $2 million a day, a significant drop in its Fortune 500 status, and impending bankruptcy, which do not support a finding of commercial impracticability); *Langham-Hill Petroleum Inc v Southern Fuels Company*, 813 F2d 1327, 1330 (4th Cir 1987) ("If fixed-price contracts can be avoided due to fluctuations in price, then the entire purpose of fixed-price contracts, which is to protect both the buyer and the seller from the risks of the market, is defeated.").

9. Comment 4 to MCL 440.2615.

10. *Id.*

11. *See USC Corp v Int'l Minerals & Chemicals Corp*, 1989 WL 10851, at *2 (ND Ill Feb 8, 1989) (affirming dismissal of commercial impracticability defense on summary judgment and holding that "[t]here is nothing in the evidence presented to support an argument that a decline in the price of ammonia or natural gas was a non-occurrence which was a basic assumption on which the ammonia contract was based" because "it is well established under Illinois law that a decline in market price, standing alone, cannot be the basis for a defense of commercial impracticability.").

12. *See Steel Indus, Inc v Interlink Metals & Chems, Inc*, 969 F Supp 1046, 1054 (ED Mich 1997) (granting steel manufacturer summary judgment and holding that raw materials supplier could not rely on force majeure because, notwithstanding the higher cost, there were alternative sources of supply it could obtain to meet its contractual obligations).

13. *See Steel Indus, Inc*, 969 F Supp at 1053-54 (holding that seller was not relieved of obligation to supply steel because seller's steel supplier was not contracted as sole-source supplier and "[t]he matter of obtaining a source of steel ordered by [plaintiff] was entirely the responsibility of and at all times within the control of [defendant]"); *Chemtron Corp v McLouth Steel Corp*, 381 F Supp 245, 257 (ND Ill 1974) (a force majeure provision did not excuse the seller of obligation to deliver liquid nitrogen and oxygen because seller failed to employ reasonable alternative means for fulfilling its supply obligation).

14. MCL 440.2615(c).

15. MCL 440.2615(b) ("Where the causes mentioned in paragraph (a) affect only a part of the seller's capacity to perform, he must allocate production and deliveries among his customers but may at his option include regular customers not then under contract as well as his own requirements for further manufacture. He may so allocate in any manner which is fair and reasonable.").

16. Comment 11 to MCL 440.2615.

17. *Gulf Oil Corp*, 706 F2d at 455; *see also id* at 454 ("in order to use *force majeure* events to excuse nonperformance, Gulf [Oil] must show that it tried to overcome the results of the events' occurrence by doing everything within its control to prevent or to minimize the event's occurrence and its effects.").

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