Hogan Lovells

Sovereign Investor Insights

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Investment risk and COVID-19

The COVID-19 illness that has swept into at least 200 countries worldwide and infected more than two million people was officially designated a pandemic by the World Health Organization (WHO) on 11 March. In addition to the humanitarian and public health dimensions of the outbreak, governments have implemented drastic measures to mitigate the spread of the virus, including quarantines, closure of bars and restaurants, bans on mass gatherings, and strict travel restrictions.

In light of these actions, investors, their counterparties, and portfolio companies will need to assess whether the COVID-19 pandemic is a valid ground for triggering contractual provisions governing material adverse change and force majeure in order to relieve themselves of existing contractual obligations.

Force majeure clause

A force majeure clause is a contractual provision that excuses a party's performance under a contract when circumstances arise beyond that party's control, making performance inadvisable, commercially impracticable, illegal, or impossible.[1] Although force majeure was historically equated with an "act of God" such as natural disasters, earthquakes, or floods, the term has since been expanded to encompass other events, including strikes, market shifts, terrorist attacks, computer hacking, and government actions.

In California, the primary test for force majeure is determining whether the particular event impeding performance "could not have been prevented by the exercise of prudence, diligence and care."[2] In considering the applicability of this test, courts have focused on (1) whether the event qualifies as force majeure under the contractual language; (2) whether the risk of nonperformance was foreseeable and able to be mitigated; (3) causation between the force majeure event and the resultant non-performance; and (4) whether performance is truly impracticable.[3] While California excuses performance where impracticable, such that it would require excessive or unreasonable expense, other jurisdictions, including New York, excuse performance only where destruction of the subject matter of the contract or the means of contractual performance make the satisfaction of obligations truly impossible.[4]

Parties cannot invoke force majeure where the potential nonperformance was foreseeable and could have been prevented or otherwise mitigated, as parties are under an obligation to mitigate any foreseeable risk of nonperformance.[5] Many contracts also require that a party seeking to enforce a force majeure provision in order to suspend or terminate performance must provide notice. Failure to provide notice according to the specifications noted in the contract may result in waiver of the clause. Even if force majeure is successfully invoked, the party asserting the defense typically has an obligation to take actions to mitigate, the extent of which is usually described in the force majeure clause itself (such as commercially reasonable efforts generally, specific work-around plans, etc.).

COVID-19 as a basis for invoking force majeure

In analyzing whether a court or arbitration panel will find that COVID-19 excuses performance, it is imperative to scrutinize the specific language of the force majeure clause, as well as the applicable law in the governing jurisdiction. Some clauses may specifically mention disease or illness, while others may generally reference causes beyond the parties' reasonable control, or "acts of God." Unless the contract specifically mentions pandemic, viral outbreak or illnesses, there will likely be a dispute over whether COVID-19's impact on the parties' performance constituted an "act of God," or whether it was sufficiently foreseeable that it should have been more specifically written into the contract.

While the question of whether a pandemic constitutes a force majeure event turns on the language of the provisions and applicable law, U.S. case law involving disease outbreak similar to COVID-19 is limited. In the relatively few judicial opinions that have analyzed whether a certain disease outbreak constituted a force majeure event, courts have focused on the actual language of the clause, as well as the extent to which the outbreak was an unforeseeable event precipitating a dramatic change in market conditions and rendering performance truly impossible.[6] Here, the fact that at least 200 countries have reported COVID-19 cases to the WHO distinguishes it from other epidemics and weighs in favor of this pandemic being considered a force majeure event. Of note, this is only the sixth time that the WHO has declared a disease outbreak to be a Public Health Emergency of International Concern (PHEIC) since being vested with that authority in 2005, two years after the Severe Acute Respiratory Syndrome (SARS) outbreak.

However, even if the COVID-19 outbreak is not considered a force majeure event because it does not make performance essentially impossible, the quarantines, travel restrictions, or other related limitations on normal business imposed by governments may constitute valid government action excusing performance.[7]

Given the current crisis, courts in the United States may be more willing to find that both the outbreak and governmental responses were unforeseeable events or beyond the control of either party, making it more probable that force majeure invocation would prevail to suspend, defer, or release a party from contractual obligations at least for a period of time. However, parties must also be actively planning for government restrictions to be lifted or modified in the coming weeks, and should be ready to address their obligations to mitigate the force majeure by trying to make up lost time, which will not be easy.

Material adverse change clauses

If a force majeure claim cannot be sustained, many contracts also contain a clause allowing termination or adjustment of obligations in the event of a "material adverse change" (MAC).[8] A typical MAC clause would allow a party to terminate a definitive agreement in the event that there is a material adverse change with respect to the target business after the signing date.[9] What constitutes a MAC is negotiated between the parties and is often subject to a number of exclusions, which may themselves be subject to carve-outs (e.g., to the extent an applicable condition or circumstance has a disproportionate effect on the target business as compared to other companies in the same industry). However, courts have held that an adverse change is material only if it substantially threatens the fundamental agreement in a durationally-significant manner; a short-term hiccup in earnings, for instance, will not constitute an enforceable MAC.[10] As a result, each MAC clause is highly fact and contract-specific, but the party arguing MAC generally has the more difficult argument.

Whether a party can successfully argue that an event triggered the MAC clause under a particular agreement depends heavily on (1) how the clause is drafted, (2) how the clause will be construed under the agreement's governing law, and (3) the actual impact on the business at issue. In order for a MAC clause to be enforceable, the intentions of the parties should be clear and the trigger for invoking the MAC clause should ideally be objective in an effort to avoid costly litigation with a very uncertain outcome. Courts construing MAC clauses have encouraged the parties to agree on specific adjustments or conditions or termination clauses for known risks, and not leave them to the courts to assess whether they rise to the level of a MAC.

MAC clause and COVID-19

Whether an event such as COVID-19 is sufficient to trigger a MAC clause depends in large part on the invoking party's ability to meet the heavy burden of showing that the crisis has caused an adverse change that is material to the agreement as a whole. Prior court decisions provide little to no guidance on whether an outbreak of disease (such as SARS or the swine flu) constitutes a MAC. As with force majeure, the longer COVID-19 persists and the more economic harm it causes, the higher the likelihood that the invoking party can successfully argue COVID-19 has triggered a MAC clause. The language of the MAC, including the carve-outs contained in the agreement, will be a key factor in such an analysis, particularly the carve-outs that exclude events which affect the economy or industry generally and do not have a disproportionate impact on the specific company.

Loan facility agreements entered into by borrowers and portfolio companies in lower and middle market deals

usually contain standard MAC clauses as one of several potential events of default. However, as COVID-19 continues to evolve and finances of businesses likely deteriorate, other events of default, in particular breaches of financial covenants, are likely to be the first trigger entitling lenders to demand early repayment of loans. Taking into account the numerous businesses that were able to bounce back after the SARS outbreak in 2003, lenders will likely evaluate the risks on a case-by-case basis before deciding whether to accelerate their loans in light of COVID-19.

Next steps: preparing for potential triggering of force majeure and/or MAC clauses

While removing risk is impossible, investors should prepare for any potential triggering of MAC and/or force majeure clauses by assessing their (and their counterparties') rights under such clauses as they relate to the developing COVID-19 pandemic. Further, in an effort to mitigate future risk, if any negotiations are ongoing, perhaps in relation to the acquisition of a portfolio company or the disposal of existing portfolio investments that may suffer from the impact of the COVID-19 outbreak, investors should assess to what extent other viral outbreaks or public health issues should be specified as, or carved out, from MAC or force majeure clauses.

The above represents our latest thinking in "real time" and will likely evolve over the coming weeks and months. Our teams of lawyers across the globe are continuing to compile the latest thinking and legal guidance on the coronavirus outbreak. To track our latest updates, which will include more specific discussions of particular contractual concepts, we encourage you to check the Hogan Lovells COVID-19 Topic Center, which covers a wide variety of practice areas across the globe.

This Sovereign Investor Insights is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed below.

Endnotes

1. *See Cal. Civ.* Code § 1511; *see also* TRACY BATEMAN ET AL., 77 A CORPUS JURIS SECUNDUM, SALES § 370; MARIE K. PESANDO, AMERICAN JURISPRUDENCE 2D ACT OF GOD § 13.

2. *Horsemen's Benevolent & Protective Ass'n v. Valley Racing Ass'n,* 4 Cal. App. 4th 1538, 1564-65 (Cal. Ct. App. 1992) *(quoting Pacific Vegetable Oil Corp. v. C.S.T., Ltd.*, 29 Cal. 2d 228, 238 (Cal. 1946)).

3. *Habitat Trust for Wildlife, Inc. v. City of Ranco Cucamonga* 175 Cal. App. 4th 1306, 1336 (Cal.Ct. App. 2009).

4. *Kel Kim Corp. v. Cent. Mkts., Inc.*, 70 N.Y.2d 900, 902 (1987) (holding that force majeure defense is narrow and excuses nonperformance "only if the force majeure clause specifically includes the event that actually prevents a party's performance").

5. *See Hay Haulers Dairy Employees & Helpers Union*, 45 Cal.2d, *supra note* 4; *see also* 6 CORBIN ON CONTRACTS, § 1342, at 328.

6. *See Rembrandt Enterprises v. Dahmes Stainless*, No. 15-cv-4248, 2017 WL 3929308, at *2, *12 (N.D. Iowa Sept. 7, 2017) ("In the spring of 2015, an epidemic of Avian Flu hit the Midwestern United States. The outbreak was notorious and engendered a large amount of media coverage and government intervention;" the flu devastated a poultry farmer's egg production operations and he was forced to shutter plans to build a new location; farmer sought to cancel its order of a commercial dryer for that cancelled location, as a result of the purported force majeure; the court refused, reasoning that the effects of the Avian flu did not affect the ability of the supplier to build and deliver the dryer).

7. *See, e.g., Harriscom Svenska, AB v. Harris Corp.*, 3 F.3d 576, 580 (2d Cir. 1993) (holding force majeure clause which included "governmental interference" excused performance when the government forbade shipping orders to Iran); *Duane Reade v. Stoneybrook Realty, LLC*, 882 N.Y.S.2d 8, 9 (App. Div. 1st Dep't 2009) (A New York appellate court applied a force majeure clause that included "governmental prohibition" to excuse performance interrupted by a judicial restraining order. The court reasoned that a judicial order, though not specifically enumerated, fit into the category of governmental prohibition.).

8. For the purpose of this analysis, MAC and Material Adverse Event (MAE) clauses are treated similarly.

9. *Akorn, Inc. v. Fresenius Kabi AG*, No. 2018-0300-JTS, 2018 WL 4719347, at *47 (Del. Ch. Oct. 1, 2018).

10. *In re IBP, Inc. Shareholders Litigation v. Tyson Foods, Inc.*, 789 A.2d 14, 68 (2001).

Authors

Christopher J. Cox
Partner
Silicon Valley
T +1 650 463 4078
chris.cox@hoganlovells.com

Joseph Spoerl
Associate
Silicon Valley
T +1 650 463 4159
joseph.spoerl@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Berlin**
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
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Washington, D.C.
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