Disrupted Economic Activity and Force Majeure – Avoiding Contractual Obligations in Time of Pandemic

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Overview

The China-originated virus that has impacted major parts of the globe, including the United States, has created health problems for some and, in the United States, governmental reaction to it has created legal and economic issues for many more. One of those legal issues involves existing contracts. In the United States, the issuance of various Executive Orders by state governors as a result of the anticipated impact of the virus has shut down significant economic activity in those states and triggered problems up and down the food supply chain. What happens when a supply chain is disrupted? What recourse exists for a farmer that entered into a contract to sell corn to an ethanol plant, and now the ethanol price has collapsed and the plant refuses to pay? What if a hog buyer won't buy hogs because the processing plant is shut-down? What if a milk buyer backs out of a milk contract because the milk market has disintegrated? Grain can be stored and milk can be dumped, but what do you do with a 300-lb. fat hog?

The non-performance of contract obligations in the time of massive economic disruption and the concept of "force majeure" – it's the topic of today's post.

Force Majeure

Clause contained in a written contract. A common provision in some agricultural contracts (particularly hog production contracts) is known as a "force majeure" provision. Under such a provision, a contracting party is not liable for damages due to the delay or failure to perform under the contract because of an event that is beyond the party's control. Performance is excused until it becomes possible for the party to perform under the contract. But, does the China Flu (commonly referred to as COVID-19) constitute an event covered by a force majeure provision that would excuse a contracting party's performance? Recently, some hog integrators, ethanol plants and contract milk buyers have claimed that it does and have attempted to either terminate or renegotiate contracts with farmer-producers.

Force Majeure means "superior force" or "unavoidable accident." It applies when there are circumstances beyond a party's control that excuses the party from performing, such as an extraordinary event like war, riot, crime, pandemic, etc. Most often, a "force majeure" event involves an "act of God" (i.e. flooding, earthquakes, or volcanoes) or the failure of third parties (such as suppliers and subcontractors) to perform their obligations to a contracting party. However, sometimes a contracting party will attempt to use the clause to extract themselves from a contract that has turned out to not be profitable for them.

A force majeure clause is not uncommon in contracts. It concerns how the parties allocate risk and, in essence, frees the contracting parties from liability or obligation when an extraordinary event or circumstance beyond their control prevents at least one party from fulfilling their contractual obligations. The event or circumstance must be one that the parties couldn't have anticipated at the time the contract was entered into; the party seeking to remove themselves from the contract must

not have caused the problem; and the event or circumstance makes it impossible or impractical to perform the contract. As noted, a force majeure clause can apply when the contract is impacted by a war or strike or riot or an epidemic or pandemic or some other event that is deemed to be an "act of God" such as a flood, or earthquake, etc. But, the clause does not cover occurrences that are within the control of a contacting party such as negligence or a party's malfeasance (misconduct or wrongdoing) that significantly impacts the ability of the party to perform under the contract. A force majeure clause is not intended to shield a party from the normal risks associated with an agreement. *See, e.g.,* *The Pillsbury Company v. Well's Dairy, Inc., 752 N.W.2d 430 (Iowa 2008)*. In addition, non-performance may, however, only be suspended for the duration of the event or circumstance that triggered application of the clause.

The wording of a force majeure clause is critical and should be negotiated by the contracting parties so that it applies equally to all parties to the contract. Often, it is helpful if the clause includes examples of acts that will excuse performance under the provision. The following is a sample force majeure clause that is being used in some hog production contracts in Iowa:

"Any party to this agreement shall be relieved of its responsibilities and obligations hereunder when the performance of those responsibilities and obligations becomes impossible because of, but not limited to, acts of God, war, disaster, destruction of the party's facilities not attributable to the action or inaction of the party, or change in governmental regulations or laws making this agreement illegal."

The provision's language is fairly standard force majeure language and includes examples of what events excuse nonperformance – acts of God, war, disaster, and change in regulations or law that make the contract illegal. But, is the present virus a covered event? Some hog integrators think so, as do some ethanol plants and milk buyers. Some of these parties are having their suppliers allege force majeure on them, citing current market conditions as a result of executive orders of state governors.

There is no "one-size-fits-all" force majeure clause language that will work for all contracts. In addition, the contracting parties should specify the affected party's obligations upon the occurrence of a Force Majeure event. Perhaps the affected party should be given more time to perform under the contract rather than being completely excused from performance. The point is that "boilerplate" clause language will likely not properly allocate the risk between the parties. While the future is difficult, if not impossible to predict, thought should be given to the contingencies that might occur that are beyond the control of the parties and how risk should be allocated upon the happening of an unforeseen circumstance that renders performance impossible.

No clause language. If a contract doesn't contain a force majeure clause what happens? In that event, common law principles apply. How does the law deal with unforeseen events? One common law principle is "frustration of purpose." This can serve as a defense to contract enforcement and applies when some event that the parties did not contemplate makes contract performance substantially different than what the parties originally bargained for. Sometimes, frustration of purpose can be the result of government action. Impossibility of performance may also be another common law principle that might be invoked.

Without a force majeure clause, the basic assumption is that the risk associated with an unforeseen event was not assigned and performance is not possible. But, the common law typically looks to the impracticability of performance. But a question is commonly raised as to whether part performance can be made. If so, it will be required. But, remember, if performance can be rendered but doing so would result in a bargain that is completely different from what was originally bargained for, "frustration of purpose" may be a complete defense to performance.

What is covered? Some force majeure clauses also include acts of government. That's an important point with respect to the present virus. The virus is not disrupting supply chains and causing contract legal issues. State governors are issuing Executive Orders dictating the businesses that can operate and those that cannot. These diktats, constitutionality aside, are having a significant negative impact on supply chains. For those force majeure clauses that include acts of government, an argument can be made that the clause will apply. However, the present economic chaos is not being created by a "change in governmental laws or regulations" that make the contract illegal (as the sample language quoted above states it). It is being created unilaterally by state governors. There has been no deliberative legislative body enact a law or a regulatory agency promulgate regulations after going through the notice and comment procedure. So, with respect to the virus, is it really "government action" that would be included in force majeure clause language? That perhaps is an open question. Standard force majeure clause language may need to be modified to account for these emergency declarations.

"Acts of God"

A contract may distinguish between "acts of God" and force majeure, and a contract may include an "act of God" clause rather than a force majeure clause. Many contracts contain language specifying that if a particular event occurs, then no performance is required. That type of language tends to deal with "acts of God." Again, it's a matter of how the parties allocated risk. For example, agricultural leasing arrangements are generally differentiated by the allocation of risk between the landlord and tenant. While this is a function of the type of lease involved, risk allocation is also dependent upon the terms of a written lease agreement or common law principles for oral leases. For example, a clause common in many leases requires the tenant to farm the land in accordance with good farming practices (i.e., not commit waste on the premises). *See, e.g.,* *Keller v. Bolding, 2004 N.D. 80, 678 N.W.2d 578 (2004)*. As a result, an understanding of the potential legal and economic risks involved in a leasing relationship and the negotiation of lease terms is very important. With that notion in mind, consider the case of *K & M Enterprises v. Pennington, 764 So. 2d 1089 (La. Ct. App. 2000)*. In this case, the plaintiff leased ground from the defendant and planted 406 acres to corn. The growing crop was consumed by deer, and the tenant sued to recover the lost crop. The issue was whether the tenant bore the risk of the loss of the corn crop. The court determined that he did. The parties had a written lease, and the court determined that the contract language was clear and unambiguous. "Acts of God" were among the risks assumed by the tenant. While the parties clearly were thinking weather-related events to be "acts of God" that the tenant would assume any resulting damage on account of (and not consumption of the corn crop by deer), the court concluded that the complete devastation of the crop by deer was such an event. In addition, while the tenant sought permission (largely after the fact) to put up an electric fence, the court held that right was not included in the landlord's responsibility to convey "peaceable possession" to the tenant.

Is the virus such an event that is comparable to those that fall under the category of an "act of God"? It likely is. Similar to the deer destroying over 400 acres of corn in *Pennington*, a pandemic isn't typically an event that is foreseen. While it's not a weather-related event that an act of God clause contemplates, it could be treated as an act of God. Thus, how the parties contractually allocated that risk is critical.

Other Possible Protection

In some states, an agricultural producer may be able to obtain a lien under state law to protect against contract termination or non-payment. For example, Iowa law provides for the filing of a "Commodity Production Contract Lien" with the Iowa Secretary of State's office (commonly referred

to as a "contract finisher's lien.) *Iowa Code §579B.* The law applies to a "contract livestock facility" which is defined as an animal feeding operation where livestock is produced according to a production contract by a contract producer who owns or leases the facility. *Iowa Code §579B.1(4)*. A qualifying "production contract" is an *oral or written* agreement that provides for the production of a commodity by a contract producer that is in force on or after May 24, 1999. *Iowa Code §579B.1(16).* A lien of this type is an agricultural lien and a producer who is a party to a production contract, if properly executed, automatically has a lien and the buyer is automatically a debtor, owing the amount under the contract in the event of a default. *Iowa Code §579B.4(1)(a)*. State law in some states may also provide for a lien that could apply in the case of corn grown and sold under contract to an ethanol plant.

Interstate Commerce Issues

As noted above, it has been the unilateral actions of state governors that has had the effect of largely shutting down the national economy. The Congress has reacted by providing (at this time) $2.2 trillion in federal spending to deal with the economic effect of the actions of the state governors. Over 22 million people have filed for unemployment compensation. The governors' actions have had a national interstate effect. State governors, however, do not have plenary police power when the exercise and effect of that power impacts interstate commerce. There has been much debate and discussion about federalism (the manner in which power is shared between the federal and state governments). What the governors are doing, however, has little to do with federalism. Clearly, the states have the power to regulate commerce within their respective boundaries. But, the Congress, under the Constitution, has the exclusive constitutional power to regulate interstate commerce. *U.S. Constitution, Article I, Section 8, Clause 3.* But, the discussion and analysis doesn't end there.

While "commerce" is not explicitly defined in the Constitution, its interpretation determines the dividing line between federal and state power. Likewise, how "interstate" commerce is to be viewed remains debatable. In any event, however, the actions of state governors via executive orders that shut down selective businesses, etc., have affected interstate commerce in a very negative way. As such, they are largely unconstitutional on Commerce Clause grounds based on U.S. Supreme Court opinions dating back over 80 years. In those cases, the Supreme Court has determined that activity constitutes "commerce" if it has a "substantial economic effect" on interstate commerce or if the "cumulative effect" of one act could have such an effect on commerce. For example, in 1937, the U.S. Supreme Court said, in a case involving alleged unfair labor practices, that "though activities may be intrastate in character when separately considered, if they have such a close and substantial relation to interstate commerce that their control is essential or appropriate to protect that commerce from burdens and obstructions, Congress cannot be denied the power to exercise the control." *NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937).* Thus, even within a state, if commerce is regulated in a way that it harms interstate commerce, only the Congress has the power to regulate it. Indeed, in 1942, the U.S. Supreme Court dealt with a case involving a farmer that grew wheat and consumed it on his own farm. *Wickard v. Filburn, 317 U.S. 111 (1942).* The wheat never touched interstate commerce. Even so, the Court said his conduct could still be regulated by the Congress because, "the stimulation of commerce is a use of the regulatory function quite as definitely as prohibitions or restrictions thereon." Even purely local activity can impact the interstate commercial economy. As an example, the Court has upheld the federal regulation of intrastate marijuana production. *Gonzales v. Raich, 545 U.S. 1 (2005).*

This all means that it is the Congress that has the power to stimulate (and regulate) interstate commerce and, therefore, if actions are taken in a state that either prevent the stimulation of or have the effect of regulating interstate commerce, the federal government can act. The President, as the

head of the executive branch and via the Justice Department certainly has the constitutional authority to do so. To say that the President, as some have claimed, is powerless to make decisions concerning economic activity and that those decisions lie solely with the governors is absurd. The only argument is whether the President can act alone or whether the President's power is concurrent with the state's power to regulate intrastate activity. However, the issue is not a federalism issue, it's a commerce issue and one where the conduct of governors has certainly had widespread interstate commerce economic impacts. While some of the state governors may believe that federalism gives them all of the power without accountability to deal with public health issues, that's not the way that federalism works. It's also not the manner in which the U.S. Supreme Court has interpreted the Commerce Clause in a very long time.

Conclusion

The actions of state governors in response to the virus has disrupted economic activity and has had a significant impact on agricultural contracts. Whether a party can be excused from performing, such as buying corn or hogs or milk, depends on the contract language and, perhaps, the common law in a particular jurisdiction. Farmers who find themselves in the situation of contract termination on the basis of "force majeure" would be well-advised to seek legal counsel immediately. By accepting a contract termination or failing to respond to an attempted termination, a contracting party implicitly agrees to mitigate their own damages. Mitigation of damages requires a reasonable effort to contract with another source. Hopefully, the restrictions on economic activity will be short-lived and the contract issues some farmers are facing will diminish.