Coronavirus and Force Majeure Clauses: Considerations for Industrial Projects and Distribution Chains

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COVID-19 shut down significant commercial centers, initially in China but then in much of Europe and North America. This, combined with both governmental and privately imposed travel restrictions, has placed a chokehold on manufacturing and shipping sources.

With the specter of the virus’ impact worldwide, purchasers and suppliers outside must take this threat seriously and focus on their contractual options, liabilities, and obligations. Even for those who do not have any part of their supply chain connected to China, it has become clear the impact will not be limited to that country’s customers.

Most supply and equipment purchase agreements will provide for an excuse for delay or failure in performance (or relief from liability for such delay or failure) as a result of an event of force majeure, which is generally described as an event outside of the reasonable control of the affected party or an act of God. The consequence of an invocation of such a clause is either a permitted delay in the performance of work, adjustment to project schedules (and potentially costs), or the termination of the agreement by the party not affected by the force majeure event (although some agreements will
make this ability mutual, generally because of the impact such a delay will have on agreements that take up production or performance capacity at later points). Whatever the impact, and regardless of whether a party has already claimed the current outbreak as a force majeure event, those who decide to take steps only once the force majeure event has been claimed may find themselves with few or no options.

Planning for the impact of a potential force majeure event and committing resources to mitigate adverse consequences can significantly reduce the pain likely to result from such events. This is true on both the purchasing and the supply side of the equation.

On the purchasing side, companies need to fully understand how suppliers are affected by this kind of a force majeure event. Even if suppliers do not have a country-of-origin designation with a country that is fully impacted on their contractual documentation, that does not mean the supply chain required for the supplier is not directly and adversely impacted, as supply sources from sub-suppliers may be reliant on affected countries. This could be especially relevant to the extent a supplier is dependent on components or raw materials from a sub-supplier, where a substantial transformation (a change in the item justifying a change in country of origin) at the supplier or sub-supplier end may not show the countries involved further down the chain. The country of origin designation is focused on customs and tariff issues, while the correct source country of components might be entirely different.

On the supply side, producers and manufacturers would be ill-advised to rely on the availability of a force majeure clause as the best solution. Early communication with the customer will likely be better received in the long run than causing projects to collapse or supply contracts to deteriorate at a customer’s expense. In addition, many force majeure clauses will limit a party’s ability to rely on or claim an event of force majeure only to the extent the consequence could not have been avoided. The question will then become: If, with prior knowledge of the potential impact of the virus, could a supplier could have prevented the adverse outcome? The effect of the force majeure event on future manufacturing commitments needs to be carefully considered.

The ability of a sub-supplier to acquire key components and raw materials from other sources may be more limited (local) the farther down the chain one looks. Key components need to be identified on a critical path analysis on a bill-of-materials level. Suppliers should work with their customers on a prospective basis. Delay in passing on the problem will not be viewed with any favor and could easily result in the loss of a customer, while working with the customer to find an alternative source could potentially strengthen the relationship and keep the customer committed through a force majeure event.

Here are key considerations that need be addressed sooner rather than later:

1. Does the supply agreement provide for excuse of performance in the event of a force majeure?

   a. If so, the parties need to understand the following:

      i. The available supply alternatives (qualitative and quantitative);
      ii. If an extensive force majeure event allows either or both parties to terminate the agreement.
      iii. If the supplier has remediation obligations (commercial or best effort); and
      iv. The impact on project/purchase scheduling;
v. Viable market alternatives (considering timing restrictions on the purchaser);
v. The suppliers’ manufacturing schedule beyond the expected horizon of the force majeure event;
vi. When alternatives can or must be used (i.e., when can the supplier leave the sub-supplier behind);

b. Even if the agreement does not contain a force majeure clause (or the clause does not apply) most of the above factors will need to be addressed, especially in the context of large projects. Delays in such projects can be severe on both sides, regardless of which party will hold final legal responsibility. Contractually, there may also be an issue of defenses to performance under the concept of impossibility of performance.

2. Is insurance coverage available for this event? This should, of course, be part of any project planning.

Timing on these issues is important, as demand will start shifting to alternate sources, causing increases in prices and quickly evaporating available capacity. To the extent possible, purchasers should consider working with their suppliers to understand what their constraints are or might be. Avoid jumping out of the frying pan and into the fire.

There is no single answer as to how purchasers and suppliers should address the impact of COVID-19. For some, this will simply require shifting purchasing or supply lines to different locations – absorbing potential changes in cost, quality, or composition. For others, the impact of the force majeure may throw off tightly planned project schedules months or years in the making and for which the critical path contains only a limited, if any, cushion. The domino effect in such an event could either collapse a project completely or force a company to declare a force majeure event with respect to its own project and freeze subsequent steps on a larger scale. It would be folly for companies to not confront this issue now both internally and, depending on the terms of the applicable force majeure clause, with their contractual partners and sub-suppliers.

While force majeure clauses provide some protection against unforeseen events, a pandemic event such as this coronavirus should give parties on both ends of the supply chain pause and encourage them to evaluate their relevant supply chains, their use of force majeure clauses, and backup plans for when such force majeure clauses fall short of complete protection. Everyone is hoping for a quick turnaround with respect to the impact of COVID-19, but on the contractual level, it remains clear prevention will be most beneficial, even while a cure is being sought.

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